

## **BACKGROUND**

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As context for this report, this section provides an overview of City of San José's financial environment. It is useful to understand how the structural deficit occurred, as well as to review the City's efforts in addressing the situation during the last seven years.

However, before focusing on San José specifically, the reader should be aware that many cities and counties in California are facing "structural deficit" problems. These financial stresses are related to increasing service demands, aging infrastructure and escalating personnel costs, often linked to pension increases. Compounding these expenditure drivers is the fact that in California local revenues are constrained by various Constitutional initiatives approved during the last 30 years as well as the shifting of local property taxes to the state. These general issues have been exacerbated in San José by the extreme economic swings the underlying economy has experienced over the last ten years.

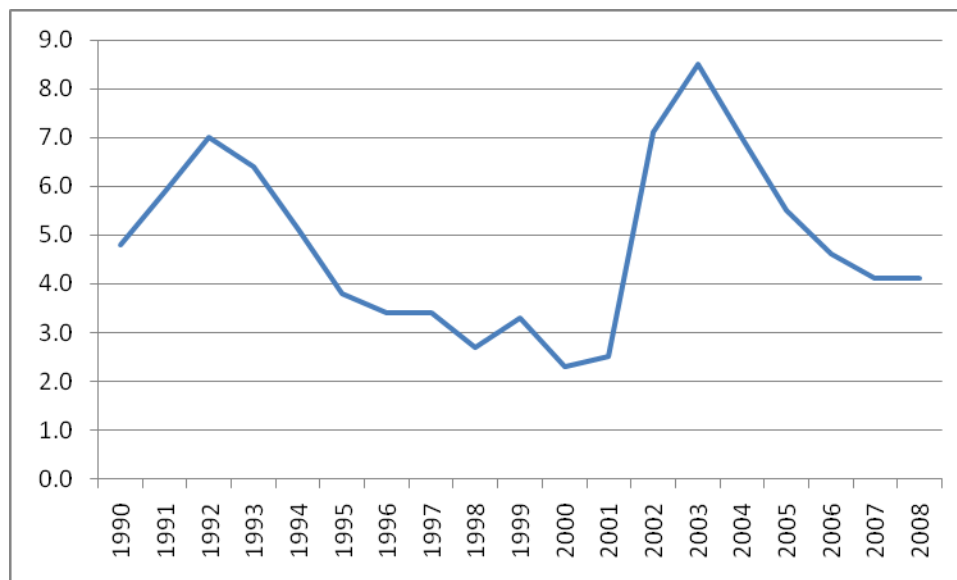
### **The Dot-com Boom and Bust**

To understand the current financial position of the City and to put the structural deficit, and the potential strategies for closing it, in perspective, an understanding of the economic trends that have impacted the City is necessary. In order to understand the root causes of the City of San José's structural budget deficit, one must have an appreciation for the significant economic rollercoaster experienced in the last decade.

Between 1990 and 1997, the unemployment rate in San José ranged from 3.9% to 7.0%. Economists consider an unemployment rate of roughly between four and six percent "normal" and consistent with a growing economy since people move in and out of the job market for a variety of reasons and, therefore, at any given time, there is always some level of unemployment. The City and surrounding economy did, in fact, grow steadily during the first six years of the 1990s.

Starting in 1997, an unprecedented decrease in the unemployment rate in San José was observed. Ultimately the rate fell to a very low 2.3% in late 1999. The trend in the San José unemployment rate over the last 18 years is shown in Figure 2 below.

**FIGURE 2: SAN JOSÉ UNEMPLOYMENT RATE 1990 TO 2008**  
**(PERCENT OF ACTIVE WORKFORCE UNEMPLOYED AND SEEKING WORK)**



Rates of unemployment under 3%, like that which occurred in San José during 2000 and 2001, are very uncommon. In fact, this is the lowest unemployment rate ever recorded in a large California city since the statistic has been calculated. This finding is consistent with an “overheated” economy, and indeed during this time employers in the San José/Bay Area, especially traditional employers like the City of San José, had great trouble filling vacancies. For example, in 2000 the City was forced to create a hiring “SWAT Team” charged with filling approximately 100 high priority vacancies.

During Fiscal Year (FY) 2000-01, the City averaged only 3.7 job applications per job appointment. Year to date data for FY 2008 shows that this statistic is now running at 19.7 applications per job appointment. The point is that during 2000 and 2001 the inability to fill City jobs and reduce high vacancy rates was a huge problem; one that demanded the same degree of attention now focused on the structural budget deficit.

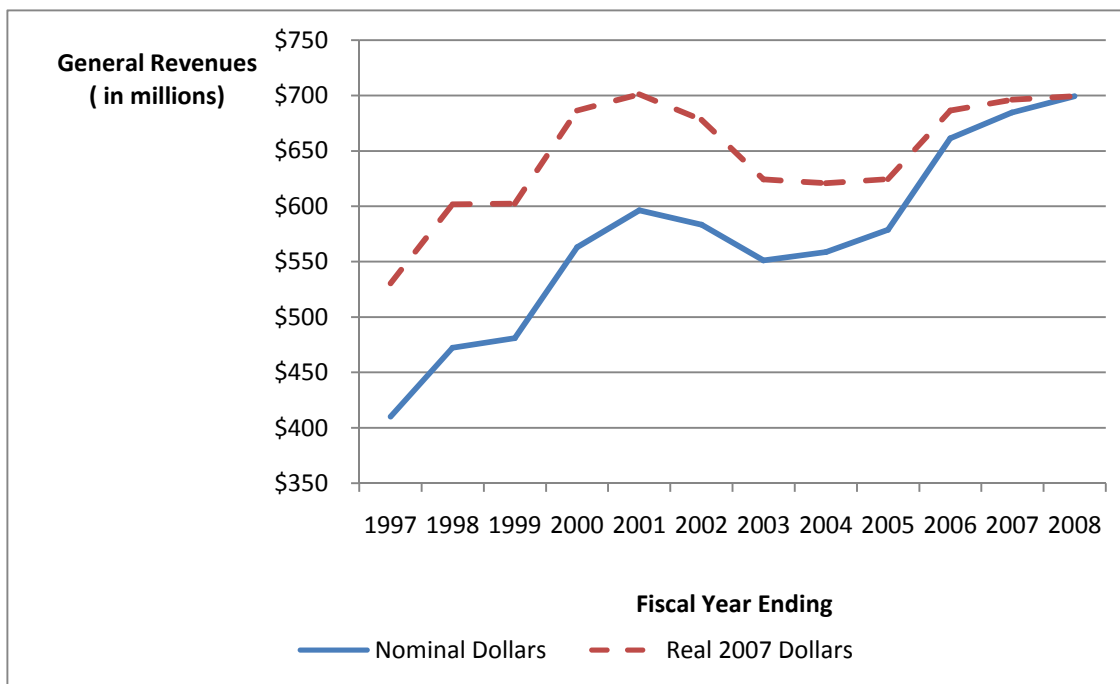
Unfortunately, what came to be known as the dot-com bubble of the late 1990’s and early 2000s was followed by the dot-com bust in late 2001. (According to the U.S. Labor Department, the recession actually started on March 10, 2000. However, the Bay Area Economic Index, a leading indicator calculated by the Bay Area Association of Governments which uses local data on airline activity, regional and semiconductor sales, in addition to national data, hit a high of 2.10 in October 2001, fell to a low of 1.53 in May 2003, and has yet to regain the 2001 level.) In San José, nearly 200,000 jobs were lost during this recession and the unemployment rate soared above 8%. Over 158,000 jobs were lost in just 2001 and 2002. (The unemployment rate would have been higher, but many workers who had relocated to San José left the area.)

## Fiscal Performance from 1997 through 2007

City revenues tend to lag somewhat behind the general economy. The City estimates that about 50% of General Fund revenues are directly linked to the strength of the local economy. By the late 1990s the City of San José was also experiencing a pronounced increase in General Fund revenues, driven primarily by escalating sales tax and property tax revenues.

Figure 3 below shows the significant run-up in General Fund revenues that occurred during the dot-com bubble and the subsequent decline when the recession hit in 2001.

**FIGURE 3:**  
**GENERAL FUND REVENUES IN NOMINAL AND INFLATION ADJUSTED TERMS**



Between 1997 and 2001, nominal revenues grew at 10% annually. Since 2001 the growth rate has been 2.5%. Indeed, based on the estimated general revenue growth for the current Fiscal Year (2008), the City will finally return to 2001 levels in terms of real, inflation adjusted dollars. Of course, during these seven years the City's cost for personnel – its largest cost – continued to escalate.

Given the intense competition for labor which existed in San José during the dot-com bubble and the fact that City revenues were growing robustly, it is unsurprising that San José acted to increase the wages

and benefits of City employees, which is the largest part of overall City expenditures.

During FY 2000-01 through FY 2003-04, general wage increases amounted to approximately 23% for fire and police employees, with a somewhat lesser amount for other employees. The City also increased police and fire retirement benefits during this time period. The bulk of these increases came after the recession had set in but they were negotiated prior to that and had been locked in by contract. While these increases can be explained by the environment the City found itself in during the dot-com boom, they were not wiped away by the dot-com bust.

Unlike the technology industry (which quickly down-sized by almost 200,000 jobs), the City as a traditional public employer is not in a position to unilaterally alter compensation benefits or lay-off employees without difficulty. In addition it is important to note that the demand for City services is in many ways inversely related to the health of the local economy, so just when demand for City services increased during the recession, revenues fell. The City had to find different strategies for coping with the recession than utilized in the private sector.

## **Strategies to Date**

Caught between rising employee costs and diminishing General Fund revenues, the City had to cut expenses and try to find new revenues. Starting in FY03, the City began its efforts to downsize to the extent practical while maintaining essential services and avoiding layoffs. Fortunately, the City had established an economic uncertainty reserve fund during the height of the economic boom and, for each year, future deficit reserve funds with left over year-end fund balances which cushioned the downturn. The fact that the City had established an economic uncertainty reserve in case of a potential recession was extremely important in preventing more widespread impacts. While this reserve fund has recently been built back to \$10 million, it is only a shock absorber, not a long-term solution.

In addition to the use of these two reserve funds, the City has had to make numerous expenditure reductions. The strategies listed below, while not comprehensive, list the larger steps that were taken during fiscal years 2003 through 2008.

- Service and position reductions and eliminations
- Establishment of an Emergency Communication System Support Fee
- Use of future deficit reserves
- Use of the economic uncertainty reserve
- Fee increases to maintain or increase cost-recovery for various services

- Transfers from other funds (where allowable)
- Use of savings generated from cost-containment strategies and hiring freeze including:
  - Employee wage freeze in 2005;
  - Expenditure controls on technology, marketing, office furniture, equipment, and vehicle purchases;
  - Voluntary furloughs and special reduced work weeks;
  - Use of departmental Cost/Position Management Plans to force savings (2002-2007);
  - City-wide hiring freeze November 2001 to present (except sworn personnel, dispatchers and part-time staff).
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While these efforts have significantly mitigated the situation, the City's ability to provide services has still been hard hit. The single most powerful testament to the City's budget problems may be the balance sheet. In the period from June 30, 2002 to June 30, 2006 the City's Governmental Affairs Total Net Assets dropped from \$7.5 billion to \$6.0 billion. While this is more than just a reflection of the General Fund situation, and the City's overall financial situation is still strong, the trends have not been positive and corrections are necessary

## Seeking a Permanent Solution

Although the City has balanced shortfalls each year for the past six years, the solutions have been a combination of one-time and ongoing strategies. When one-time strategies are used, then the City is just postponing or carrying over a portion of the shortfall problem to the next year. Also, while the City has saved money in the short-term by deferring maintenance, lack of maintenance will ultimately cost the City more money.

Similarly, while the City has eliminated positions, it has tried to mitigate the impact on employees. For example, to avoid lay-offs, attrition has been used to downsize the organization. The City has also reorganized functions to reduce net staffing. The reductions have had a disproportionate impact on the organization, especially with regard to general government services and support services for police and fire. This has had some negative impacts on service delivery and employee morale, but employees in the City have accepted the reality that the work must get done with fewer people.

Nevertheless, such strategies have their place in responding to short-term challenges. It would be unwise for the City to slash services and staffing in response to a temporary drop in the economy, so the City's early efforts to "bridge" a recession with a variety of one-time cuts are understandable. In San José, however, it has progressively become more apparent that the dot-com growth period was more an anomaly than a new reality. Consequently, the City is transitioning from short term fixes to more permanent changes to match resources with expenditures.

In March 2007, Mayor Chuck Reed presented the Fiscal Year 2007-08 budget message and explicitly stated the need to find a permanent solution:

*Our budgets have been developed with the hopes that the economy would bounce back and revenues would once again boom. However, even if we benefit from an economic recovery, that will not be enough to eliminate our structural gap. The focus of this budget message is to address the structural budget deficit. A clear distinction needs to be made between ongoing and one-time cost reductions and revenues. One time options help balance a particular year's budget, but do not resolve the structural budget deficit.*

The March budget message went on to call for the formation of a Budget Shortfall Advisory Group (BSAG), with direction to develop a three-year financial strategic plan for addressing the City's structural budget deficit. The City Manager was directed to support this effort.

Since he became mayor, Mayor Reed has declared the structural budget deficit to be "Public Enemy Number One" and announced the membership of his Budget Shortfall Advisory Group (BSAG), created to recommend strategies to solve the problem.

BSAG members included:

- Chuck Reed, San José Mayor, Budget Shortfall Advisory Chair
- Ted Biagini, Chairman, Focus Business Bank and Biagini Vineyards
- Pete Constant, San José Councilmember
- Darrell Dearborn, former Senior Deputy City Manager, San José
- John Kennett, Executive Director, Rotary Club of San José
- Madison Nguyen, San José Councilmember
- Lydia Ortega, Ph.D., Chair, Department of Economics, San José State University
- Karen Willett, Chief Financial Officer, Newark Unified School District
- Roger Mialocq, Consultant Staff, Harvey M. Rose Associates

## **City Manager's General Fund Structural Deficit Task Force**

In response to this direction, City Manager Debra Figone formed a technical team, the City Manager's General Fund Structural Deficit Task Force, set to meet from September 2007 to January 2008. The Task Force, comprised of internal City staff, was created to develop short- and long-term alternatives and strategies to address the deficit within three years with full stakeholder input, and to then present these strategies to

the Mayor's Budget Shortfall Advisory Group with the goal that they be considered in developing the FY 2008-09 budget.

Task Force members included:

- Kay Winer, City Manager's Office/Team Sponsor
- Jennifer Maguire, Budget Office/Team Leader
- Larry Lisenbee, Budget Office
- Margaret McCahan, Budget Office
- Mariah Dabel, Budget Office
- Marianne Bourgeois, Budget Office
- Mark Danaj, Human Resources Department
- Susan Devencenzi, City Attorney's Office
- Alex Gurza, Office of Employee Relations
- Scott Johnson, Finance Department
- Leslye Krutko, Housing Department
- Jane Light, Library Department
- Karin Murabito, City Attorney's Office
- Randy Murphy, Information Technology Department

## **Concurrent Efforts Related to the General Fund Structural Budget Deficit**

There are several other issues that have a bearing on the General Fund structural budget deficit which are being studied in more detail by other staff task forces within the City. In the section that follows, we have provided an update on these activities and how they integrate with the work of the General Fund Structural Deficit Task Force work. These issues involve the City's deferred maintenance and infrastructure backlog, the partially unfunded retiree healthcare costs, and an analysis of public/private partnerships concerning complications created by the City's prevailing wage policies when applied to the donation of maintenance on City parks and facilities.

### **Deferred Maintenance and Infrastructure Team**

Since February 2007, the City Council has identified reducing the City's deferred maintenance and infrastructure backlog as one of the City's top five priorities. An interdepartmental senior staff team has been working to identify and analyze the City's deferred maintenance and infrastructure backlog since March 2007. In order to focus the work effort, the team only looked at preventive maintenance, rehabilitation and capital replacement needs, and did not include costs to maintain, operate or rehabilitate future infrastructure assets that are not yet programmed for installation.

The result of this interdepartmental work effort was an analytical report that staff presented to the Transportation and Environment Council Committee in October 2007. Condition assessments, anticipated unmet funding needs, information on existing or proposed asset management

systems, as well as some of the proposed highlights in the next two years, were included in the report. On October 25, 2007, staff also presented the findings of this report to the full Council during a half-day study session.

Of the programs and funding needs that were identified in the report, the one-time needs were estimated at \$915 million and ongoing unmet annual needs were estimated at \$45 million (all funds). During the October study session Council requested further information on the breakdown of the needs based on funding sources. This is provided in Table 1 below:

**TABLE 1: FUNDING SOURCES AND PROGRAM NEEDS**

<u>Funding Source</u>	<u>One-Time Need</u>	<u>Ongoing Annual Need</u>
General Fund	\$507 million	\$40 million
Enterprise Funds	\$305 million	\$2.5 million
Special Revenue Funds	<u>\$103 million</u>	<u>\$2.5 million</u>
Total	\$915 million	\$45 million

As discussed in the study session, staff has determined that given the General Fund deficit reported in the 2008-2012 Five-Year Forecast and Revenue Projections, limited General Fund budgeting strategies, such as creation of program reserves and sinking funds, may make sense for specific programs. However, these strategies can only be a part of a citywide strategy for meeting deferred maintenance and infrastructure needs, as any General Fund strategy would require diverting funds away from other City needs. Staff has also discussed various “near-term” funding strategies based on the needs and will continue pursuing the following ongoing strategies:

- Prioritization of critical safety needs and strategies to minimize life cycle costs;
- Continuous improvement to operational practices and preventative maintenance;
- Rate adjustments for user-financed infrastructure (e.g., sanitary storm systems); and
- Partnerships with private entities and other agencies, including grants.

Despite these strategies to maximize the efficient use of existing funds, new funding sources will be needed to address the magnitude of identified need. This is particularly challenging for programs that rely on the General Fund. Therefore, in addition to the general strategies mentioned above, a number of strategies could be evaluated for possible implementation in 2008. Some examples have been included below.

#### **1. Increase Conveyance Taxes**

Increase conveyance taxes to generate additional revenue for parks, libraries, fire, yards and communication. A 50% increase



could generate up to \$12.5 million in total additional revenue and a 75% increase could generate up to \$18.75 million in total additional revenue.

**2. Increase Conveyance Taxes and Reallocate Percentage of Funds**

In addition to increasing the taxes, staff has been exploring various scenarios for reallocation of the funds. For example, to increase funding for parks maintenance, the existing General Fund allocation of 15% could be increased to 50%. Reallocation scenarios could also explore the use of the incremental funding for some of the other categories to fund cultural facilities as well as other City assets such as police facilities.

**3. Establish a Lighting and Landscaping Maintenance District**

A Lighting and Landscaping Maintenance District could be established to plant and maintain street trees, maintain median landscaping, address the aging streetlight infrastructure and/or initiate a program to convert to more energy efficient streetlights that produce whiter light consistent with the City's green vision of energy efficiency, minimizing the impacts on dark skies and waste to landfills. This could be accomplished by a \$75 assessment per parcel which would generate about \$19.5 million in total additional revenue.

**4. Establish a Parcel Tax**

An annual parcel tax could be used in various combinations to fund parks maintenance, sidewalk repairs, ADA compliant curb ramps, repair damaged curbs and gutters, and establish a City funded sidewalk repair program.

**5. Collaborate with Other Agencies on County and/or Regional Funding Solutions to Support Pavement Maintenance**

Pavement conditions are continuing to deteriorate, especially in larger cities like San José, San Francisco, and Oakland. There are several potential initiatives being considered in the region for establishing dedicated pavement maintenance funding, although none are likely to come forward during 2008. Three examples include a Bay Area gas fee, a ¼ cent county sales tax shared between transit improvements and pavement maintenance, and a countywide vehicle registration fee increase.

At the October 2007 study session staff was directed to report back to Council in December with potential funding and implementation strategies. Council did, however, express some concern about being able to get community support to address these needs before solving the structural deficit.

The City Manager's General Fund Structural Deficit Task Force is currently evaluating some of the same strategies for new funding as the

ones listed above, and they are discussed in further detail in this report. Furthermore, these strategies could also have an impact or be impacted by the Green Vision goals, as well as the budget development activities. Thus, at this time, staff is recommending consideration of potential strategies in the context of these other concurrent efforts. It is important to note, however, that not only do the ongoing needs themselves make up more than a quarter of the structural deficit but that these, as well as the one-time needs, will only result in an even larger structural deficit if not addressed in a timely manner.

### **Retiree Health Care (GASB 43/45) Team**

The Government Accounting Standards Board (GASB) issued regulations in 2004 that became effective this year, requiring public-sector employers to account for the actuarial liability (future cost) of total retiree health care commitments. Three actuaries have been retained by the Retirement Boards and the City. Although the actuaries' calculations vary, the range of estimates for future retiree health care cost liability is from \$1.2 to \$1.65 billion. While employers are not required by GASB to set aside funds to pay for this future retiree medical cost liability in advance, there are potential negative consequences if the liability is not funded in advance. At the same time, current and future retirees are relying on the City's and employees' retiree health plan contributions for their retirement benefit. Currently, contributions for retiree medical benefits are made by the City and employees on a ratio of 1:1 (50%/50% split). A total of \$21.6 million in General Fund contributions alone would be required annually to fully fund this liability (assuming the same cost sharing arrangement).

In response to the size of this projected liability and its impact, the City Council considered this issue during two meetings in the month of August 2007. From these sessions, the City Council directed staff to:

1. Engage stakeholders in identifying strategies and alternatives to address the unfunded liability for retiree healthcare. Stakeholders will include, at a minimum, employees, City Labor Alliance, Executive Management Forum, retiree associations, retirement board and South Bay Labor Council.
2. Continue to survey how other cities and counties are addressing their unfunded liabilities.
3. Engage experts, identified by the administration and stakeholders, as necessary, to evaluate strategies and approaches that are identified by stakeholders or have been implemented in other cities or counties.
4. Study how pre-full funding of benefits can be accomplished through a phased approach.

Staff is in the initial phase of responding to the City Council's direction (items 1 and 2 above). Consultants have been engaged to meet with identified stakeholders to solicit their input and capture their ideas as well

as survey practices in other cities and counties. A report that consolidates stakeholders' input and comparable research will be submitted to the City Council in March 2008.

This report discusses some general options the City may take with regard to overall healthcare costs in the section on reducing the growth in employee wages and benefits.

### **Public/Private Partnership Team**

On September 25, 2007, the San José City Council took several actions to clarify the applicability of the City's Prevailing Wage Policy to donated services. They include:

1. Confirmed the policy applies to City maintenance projects of a routine, recurring or usual nature for City owned buildings and ground facilities, where the work performed exceeds the contractual amount of \$1,000;
2. Directed amendment of the policy to clarify that it excludes work performed by volunteers or volunteer coordinators, specific organizations, and community service days by paid employees; and,
3. Referred to the public/private partnership effort, in coordination with ongoing City Manager's Task Force work, an analysis of the implications of a policy that would exempt private sector entities that donate services for parks maintenance from the policy if the City is not paying for the work and jobs of regular City employees are not eliminated as a result of the donation.

The City of San José has a longstanding policy commitment to the payment of prevailing wages in City projects and services, to ensure equitable and sufficient wages, respect City job opportunities and employees, and stimulate the local economy. While these remain priorities, in recognition of the City's current fiscal challenges there is renewed interest in simplifying contractual requirements for private partners interested in contributing services to the City to enhance service levels. Specifically, the third element of the action above directs a closer look at how the City's Prevailing Wage Policy should apply to services donated by private companies through paid contractors.

Staff is currently working with labor stakeholders to use the experience of several public/private partnership case studies to evaluate criteria under which donated parks maintenance services could be exempt from the prevailing wage requirements. The results of this coordination will be incorporated into an overall report on public/private partnership recommendations to be released in January 2008.

At this point, it can be noted that a key emerging recommendation from this work is the need to distinguish prospective donors involved with a pending land development application from other donors such as

established businesses, resident associations, and non-profit organizations. Entities involved with development applications would be excluded from any potential prevailing wage exemption.

The financial impact of the resulting proposal is difficult to quantify, but likely consists of two primary elements: (a) the extent to which this exemption results in more donated services for parks maintenance, and (b) the relative impact of excluding development-related agreements. Staff is currently finalizing an evaluation of this approach.

Later in this report the issue of simplifying the current prevailing wage policy within the City is discussed as a potential strategy for dealing with the structural budget deficit. The financial impact of encouraging more donated maintenance by easing current restriction on use of non-prevailing wage contracts, as discussed above, would probably not be of significant fiscal impact.

## **Consultant Selection and Scope of Work**

After a competitive selection process which included response to a specific request for proposal and interviews with City staff, Management Partners was hired by the City in October 2007 to facilitate the City Manager's Task Force's identification and review of deficit reduction strategies for presentation to the Mayor's Budget Shortfall Advisory Group. Key activities for the scope of work included:

- Acquiring background information and developing a work plan
- Developing an initial list of strategies
- Conducting stakeholder focus groups
- Conducting a best practices survey
- Analyzing each strategy
- Presenting strategies for feedback
- Developing and presenting a report

More detail on each activity in the scope of work, and the results of that work, are presented in this report.

## DEFINITION OF THE GENERAL FUND STRUCTURAL DEFICIT

The General Fund structural deficit is composed of three major components: a deficit in the due to the fact that operational costs (mainly personal costs) are rising faster than operational revenues; an infrastructure and maintenance backlog (mostly street maintenance) keyed to the City's inability to completely fund replacement and renewal projects; and a deficit in the funded status of the retiree health plan. Table 2 below shows the estimated structural deficit for each component in millions of dollars over the next four fiscal years.

**TABLE 2: GENERAL FUND STRUCTURAL DEFICIT ESTIMATES BY TYPE FOR FISCAL YEARS 2009 TO 2012 (IN MILLIONS OF DOLLARS)**

	2008-2009	2009-2010	2010-2011	2011-2012	Total
Projected Shortfall (Nov 2007 Preliminary Forecast)	\$24.8	\$41.8	\$2.4	\$6.4	\$75.4
Unmet/Deferred Infrastructure & Maintenance Needs*	\$39.7	-	\$3.2	(\$2.7)	\$40.2
GASB 43/45 (General Fund Retirement Benefits)**	\$21.6	-	-	-	\$21.6
<b>TOTAL</b>					<b>\$137.2</b>

\* Assumes one-time needs of over \$500 million in the General Fund (\$900 million all funds) are addressed

\*\* City's 50% of General Fund portion of remaining annual requirement for full pre-funding (\$57 million); current annual City/employee contribution at \$43.9 million.

It is important to note that the table above assumes that the City cures the structural deficit entirely with ongoing solutions in each component each fiscal year. It is not a cumulative projection.

Under Charter requirements the City must balance the budget each year. The base deficit anticipated is \$75.4 million. However, the deficit definition was expanded at the Mayor's direction to include unmet/deferred infrastructure and maintenance needs and the unfunded retirement benefits.

## Root Causes of the General Fund Structural Deficit

The structural budget deficit has several causes. In this section of the report, the basic factors driving the deficit are explored.

As previously noted, 1997 to 2001 were especially good years for the City of San José. The Fiscal Year that ended in June 2001 was the high water mark. General Fund revenues (including the prior year fund balance) amounted to \$860 million with revenues of \$662 million; expenses were \$646 million. Fortunately the City built an economic uncertainty reserve fund with some surplus revenues that was a major buffer, which has a current balance of \$10 million.

There are two main drivers behind the current and projected General Fund Structural Deficit, and both have roots to the dot-com boom period. First, the City increased wages and benefits to compete for scarce labor. These increases have now become locked into the City's cost structure. Secondly, starting in 2000 the City embarked on a "decade of investment" and made a multi-million dollar commitment to addressing quality of life issues for San José residents, and catching up with the increased service demands created by a rapidly growing City.

Millions of dollars have been spent to build new parks, libraries, fire stations and other public facilities. Much of this capital investment came from voter approved general obligation bonds and other one-time monies. Unfortunately, to a large degree, the City was relying on continued strong revenue growth to fund the increased operating and maintenance costs associated with the new facilities. Instead the City has had to endure actual decreases in the purchasing power of General Fund revenues.

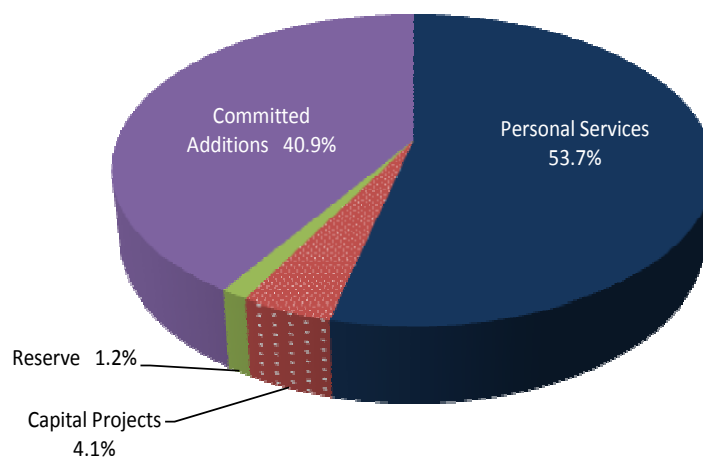
When one looks at the anticipated causes of the General Fund structural deficit projected to occur during the next few years, these factors become clear. Figure 4 below shows the anticipated contribution (or mitigation) to the structural deficit that derives from various expenditure categories. Since some expenditure categories are expected to grow at a lesser rate than General Fund revenues, these ameliorate the deficit to some extent.

As part of the 2007-08 budget process, the City researched the gap between revenues and expenditures and identified which expenditure categories were growing faster than revenues. It is important to note that these projections are for the years 2008 through 2011 and include an assumption that the Emergency Communication System Support Fee is continued. During this period, General Fund revenues are expected to grow by 3.66% annually while expenditures for personal services will grow by 4.67%. Although this is a relatively small gap, the majority of the City's budget consists of personal service expenditures, so the dollar value arising from the gap between revenue growth and expenditure increases is magnified. While committed additions (cost increases the

City is committed to fund by prior City Council action, including the costs related to maintaining and operating capital projects approved by the Council) are not a very large part of the budget, they are expected to grow very rapidly over the next four years – from \$2 million in FY 2008 to \$19 million in FY 2011.

In this analysis, when the cost categories that are expected to increase at less than the rate of increase in General Fund revenues are “netted out” from the costs expected to increase faster than General Fund revenues, the following picture emerges: most of the General Fund structural deficit is expected to come from personal services costs exceeding the rate of increase in general revenues and from the cost of new facilities and services the City is obligated to fund. Figure 4 below shows this graphically:

**FIGURE 4: RELATIVE EXPENDITURE CATEGORIES CONTRIBUTING TO THE GENERAL FUND STRUCTURAL DEFICIT 2008 TO 2011**







## **PROJECT APPROACH**

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Management Partners, working in conjunction with the City Manager's General Fund Structural Deficit Task Force (City Manager's Task Force), used a number of analytical and management techniques for this project, as described below. The combined steps enabled Management Partners to receive high-quality stakeholder input and idea generation on potential strategies, gain full understanding of the context of the City's financial crisis, and compare and contrast San José against other peer jurisdictions. With this information, we were then able to consider each proposed strategy against specific qualification/disqualification criteria to determine which were viable as recommended strategies for deficit reduction.

### **Document Review**

Management Partners acquired background information relevant to understanding the City's current fiscal status and environment. This included information about the City's budgeting methods, revenue sources and trends, expenditure allocations and trends, and labor environment. Document review provided the history of labor relations, agreements, initial assumptions and actual history. In addition, we received the economic analysis associated with labor negotiations and compared those assumptions to actual experience. We documented the performance of the private sector and private sector income levels during the trend period. Finally, we reviewed budgeting approaches and tested budget assumptions against actual experience and identified various trends.

### **Stakeholder Focus Groups**

In order to gain many opinions and suggestions regarding potential deficit reduction strategies, Management Partners facilitated five focus group sessions with key community stakeholders identified by the City. Four groups were created to include a broad cross-section of stakeholders and to be inclusive of diverse perspectives. Management Partners identified learning objectives and prepared materials to help guide the focus group discussions.

Stakeholders who participated in the focus groups included representatives from the City's Senior Staff, City Labor Alliance, City Employees, and Community and Business Groups, including City Boards and Commissions. More detail regarding the Stakeholder Focus Group process can be found in the "Stakeholder Focus Groups" section of this report and full stakeholder results are included as Attachment B.

## **Employee and Community Surveys**

To broaden the level of input by stakeholders, and to cast a wider net for creative ideas, Management Partners prepared and implemented an electronic survey of current City of San José employees and community members. The survey asked questions to gauge respondent's awareness and understanding of the City's fiscal crisis, as well as their spending priorities ideas, support for various potential strategies and new deficit reduction ideas. More details regarding the survey process can be found in the "Employee and Community Surveys" section of this report and full survey results are included as Attachment C.

## **Benchmarking**

As part of the review, Management Partners, in consultation with the City, created a list of peer jurisdictions with which we could compare and contrast the City of San José. Benchmarking provides general comparisons which are useful in pointing out any significant variances from the experiences of peers.

After reviewing cities for demographic and geographic regional similarities to San José, we presented a potential set of benchmark peers to the City Manager's Task Force and the Mayor's Budget Shortfall Advisory Group. The final list of benchmark peers included the ten largest cities in California, plus the City of Fremont which was the only other "top 20" city located in the Bay Area.

Using publicly available information, Management Partners compared various taxes and revenues, programs, and statistics among the peers as well as neighboring cities and contrasted the results against San José. Results are discussed in the "Benchmarking Results" section later in this report.

## Best Practices

Management Partners identified large cities with demographic factors similar to San José that had also dealt with budget realignments in the recent past. Best practice cities of similar demographics and who had received a Grade A in *Governing* magazine's annual list of "Best Managed Cities" are shown below in Table 3.

**TABLE 3: BEST PRACTICE CITIES/COUNTIES**

Best Practice Cities / Counties	
Phoenix, AZ	Grade A in Governing Best Managed Cities; A in Financial Management
Austin, TX	Grade A - in Governing Best Managed Cities; A in Financial Management
Long Beach, CA	Grade A - in Financial Management in Governing Best Managed Cities
Minneapolis, MN	Grade A - in Financial Management in Governing Best Managed Cities
Virginia Beach, VA	Grade A - in Financial Management in Governing Best Managed Counties
Fairfax County, VA	Grade A - in Financial Management in Governing Best Managed Counties

Management Partners researched these and other jurisdictions as appropriate to identify approaches that had proven successful in addressing ongoing budget deficits. We specifically analyzed the results of the best practice case studies to distill ideas that would be relevant to the City of San José. We incorporated the lessons learned through best practices research as we analyzed each strategy in greater detail.

## Chronology of Events for Stakeholder Input

A key instruction and goal for this engagement was the inclusion of as many stakeholders as possible (both internal and external). Multiple opportunities for stakeholder input were provided during this process. Specific opportunities held in the past and planned for the future are detailed in Table 4.

**TABLE 4: STAKEHOLDER OPPORTUNITIES TO PROVIDE INPUT**

Date(s)	Event(s)
10/01/07 10/17/07 10/29/07 11/15/07 1/10/08 1/08 TBD	Public meetings of the Mayor's Budget Shortfall Advisory Group
10/22/2007	City Manager's General Fund Structural Deficit Task Force first stakeholder focus group meeting
10/26 – 11/09/07	City Manager's General Fund Structural Deficit Task Force electronic surveys conducted
11/28-29/07	City Manager's General Fund Structural Deficit Task Force second series of stakeholder focus group meetings
12/05/07	City Manager Budget Forum conducted for employees on General Fund Structural Deficit Task Force work
1/10/08	City Manager's General Fund Structural Deficit Task Force presents final report to Mayor's Budget Shortfall Advisory Group at public meeting
1/07-11/08	Mayor conducts Community Budget Survey (scientific survey)
1/19/08	Mayor holds Neighborhood Association/Youth Commission Priority Setting Session; City Manager's General Fund Structural Deficit Task Force final report presented
2/12/08	City Council meeting to review Mayor's Budget Shortfall Advisory Committee recommendations
March 2008	Mayor's March Budget Message Study Session
March 2008	Mayor's March Budget Message Public Hearing
March 2008	City Council meeting to approve March Budget Message
May 2008	Budget Study Sessions on the FY 2008-09 Operating and Capital Budgets and Fees and Charges Report
May 2008	Initial Public Hearing on the FY 2008-09 Proposed Operating Budget, Capital Budget, Proposed Fees and Charges, and the 2009-2013 Capital Improvement Program
May 2008	City Manager Budget Forum conducted for employees
May/June 2008	Community Budget Meetings in various Council Districts for FY 2008-2009 Proposed Budget
June 2008	Final Public Hearing on the FY 2008-09 Proposed Operating Budget, Proposed Capital Budget, Proposed Fees and Charges, Mayor's June Budget Message, and 2009-2013 Capital Improvement Program.
June 2008	City Council meeting to approve FY 2008-09 Operating Budget, Capital Budget, Fees and Charges, and 2009-2013 Capital Improvement Program.

## INITIAL STRATEGY DEVELOPMENT

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The combined initial work of the City Manager's Task Force and Management Partners resulted in a very preliminary set of strategies to eliminate the General Fund deficit within three years. The list of strategies was then grouped into four discrete categories.

- Revenue Strategies: Those strategies which will increase revenues
- Service Delivery Model Changes: Those strategies which change the way in which business is conducted in order to save money
- Expenditure Controls and Shifts: Those strategies which result in better controlling costs and/or changing the way in which money is allocated to different funds in the City budget.
- Service Reductions: Those strategies that would reduce or eliminate current services to save costs.

The list of initial strategies was shared with the Mayors' Shortfall Advisory Group at their October 17, 2007 meeting for feedback. As part of getting many ideas on the table for consideration, this list was then expanded and refined based on stakeholder input and feedback, electronic survey results, and benchmarking and best practices research.

Throughout the strategy development process, we sought the answers to four basic questions: 1) What are the priorities and suggestions from the stakeholder groups?; 2) Is the City "at market" in terms of revenues, expenditures and other key variables?; 3) Are there good ideas being used in other jurisdictions that can be replicated in San José?; and 4) Can the strategy have a significant impact within a three year timeframe to eliminate the deficit?



## **STAKEHOLDER FOCUS GROUPS**

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Management Partners facilitated five stakeholder sessions to identify strategy ideas and gather feedback. Groups were created to include a broad cross-section of stakeholders and to be inclusive of diverse perspectives. Participants included representatives from the City's Senior Staff, City Labor Alliance, City Employees, and Community and Business Groups, including City Board and Commissions.

The first round of stakeholder sessions was conducted early in the project to inform stakeholders about the scale and nature of the structural deficit, listen to stakeholder opinions, and solicit structural deficit solution ideas to explore further. Eighty-five stakeholders attended and contributed in the first round of stakeholder sessions, which represented 55% of the 155 stakeholders invited to attend.

Approximately 122 new strategy ideas were recorded as the result of the first round of stakeholder input. Participants voted on their preferred strategies and Management Partners then categorized the strategies into three classifications: new, redundant with existing strategies, or non-responsive as deficit reduction strategies. Of the list created, 52 new strategies were identified for further analysis and consideration.

The second round of stakeholder sessions included four separate focus groups designed to solicit unique opinions on the advantages and concerns of each of the top strategies by stakeholder group. Individual focus group sessions were conducted with each of the following groups: City Senior Staff; City Labor Alliance; City Employees; and Community and Business Groups (including City Boards and Commissions).

Participants were asked to identify the advantages and concerns for the following initial top identified strategies by category (stakeholder feedback on the Service Reductions Category was not included as that process will be part of the 2008-2009 Proposed Budget process this May). Table 5 below shows the list of potential strategies the groups were asked to respond to. The presentation also included a brief 15-20 minute explanation of the various strategies.

**TABLE 5: POTENTIAL STRATEGIES REVIEWED WITH STAKEHOLDERS**

<b>REVENUE STRATEGIES</b>
Extend Emergency Communication System Support (ECSS) Fee
Adjust Business Tax for Inflation and Modernize the Formula
Increase Transient Occupancy Tax to Market and Shift to the General Fund and Consider Bringing the Rate into Alignment with other Large Cities having this Tax
Levy Parcel Tax for Police/EMS Services
Implement Lighting and Landscape Districts
Bring Current Fees to Market
<b>SERVICE DELIVERY MODEL CHANGES</b>
Revise Competition Policy and Implement Managed Competition for Service Delivery
Shift Economic Development/Other Costs to San José Redevelopment Agency
Eliminate Binding Interest Arbitration
Formalize and Implement Asset Management Program
Increase Utilization of Civilian Positions in Police and Fire
Modify Minimum Fire Staffing Policies in Low Density Settings
<b>EXPENDITURE CONTROLS AND SHIFTS</b>
Shift Construction and Conveyance (C&C) Tax Funding from Capital Projects to Operation and Maintenance Costs
Restructure Salary Step Increase System/Employ Market Based Compensation Benchmarks for Entry Level Salaries
Adopt a Two-Tier Retirement Program
Implement Health Care Plan Modifications
Implement Sick Leave Payment upon Retirement Program Modifications
Change Prevailing Wage Applications
Shift Healthy Neighborhood Venture Fund Funding to General Fund
<b>SERVICE REDUCTIONS</b>
Reduce/Eliminate City Services to Funding Capacity



Participants were then asked to vote for their preferred strategies. Each person was given six purple dots to vote on their preferred strategy by category (2 dots per category) and one red dot to vote on their preferred overall strategy. The results varied by stakeholder group as shown in Table 6 below.

**TABLE 6: PREFERRED STRATEGY BY STAKEHOLDER GROUP**

	<b>Overall Preferred (red dot)</b>	<b>Most Votes (purple dots), by category</b>
All Groups	Extend ECSS Fee	Extend ECSS Fee, Asset management, Shift C & C
Senior Staff	Extend ECSS Fee	Extend ECSS Fee, Eliminate arbitration, Shift C & C
City Labor Alliance	Shift costs to RDA	Extend ECSS Fee, Shift costs to RDA, Shift C & C / Shift HNVF/Increase civilianization in Police and Fire (tie)
Employees	Extend ECSS Fee	Extend ECSS Fee, Asset management, Sick leave modifications
Business and Community	Managed Competition/Shift C & C (tie)	Extend ECSS Fee, Shift costs to RDA, Two-tier retirement/Heath plan changes (tie)

The complete results of stakeholder sessions were communicated to the City Manager's Task Force and are included as Attachment B to this report. Input and feedback received through the stakeholder process informed further exploration of the strategies and is reflected in the final analysis.



## **EMPLOYEE AND COMMUNITY SURVEYS**

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As part of this process, Management Partners conducted an online survey of City of San José employees and community members. The purpose of the surveys was to gauge each group's understanding of budgetary issues and identify spending priorities and any new strategies for deficit reduction.

The surveys were conducted between October 26 and November 9, 2007, and resulted in 2,033 responses from City employees and 656 responses from community members. Employees could access the employee survey via the City's internal intranet, as well as through the Internet. Community, neighborhood, and business groups could access the community survey through the Internet. The community survey was translated into Spanish and Vietnamese. Information on the surveys was disseminated in a payroll flyer to staff, through City Manager email, a press release, and on the City's website.

The surveys consisted of 13 questions, including eight from the 2007 Community Budget Survey, four based on the list of initial strategies, and one open-ended text entry question to allow participants to express any thoughts on the topic. The surveys were not conducted in a statistically valid manner, but were considered to be one of many ways to gain valuable stakeholder feedback.

Both employee and community responses showed greater awareness of the City's budget deficit than was the case in the January 2007 Community Budget Survey. However, community and employee responses differed in terms of the preferred strategies for coping with the deficit.

On the whole, the surveys reflect a belief within the community that the City is spending about the right amount on a series of program activities from street cleaning and graffiti removal to senior citizen programs and fire services. Only a few program activity categories had "too little" spending preference chosen as the majority response. Of those, overwhelming preference was shown for street maintenance and repair and park maintenance. No program activity category was considered "too much" spending by the majority of respondents.

In general, employee responses favored the use of new or increased revenues and the use of expenditure controls and shifts while community

responses favored service delivery changes and expenditure controls and shifts. Interestingly enough, both groups felt that service delivery reductions were the “least best option.” Complete response data is available in Attachment C.

To gauge the community's response to service delivery model changes, the survey asked respondents to consider specific activities that could be performed by organizations outside of the City. The community survey respondents supported the use of outside organizations for all six categories listed. Respondents also supported consolidating departments or areas with similar missions and managing property assets more proactively.

In the area of expenditure control or service delivery reductions, the survey asked respondents to rank support and opposition for seven activity categories. Five categories including both expenditure controls and delivery reductions were supported while two categories regarding youth and senior services were generally opposed.

Comments and ideas that were written by employees and community members on the open-ended portion of the survey were reviewed and categorized. Non-duplicate ideas were recorded and applied to a set of criteria as displayed in Attachment C. Some ideas were initially screened out if they fit one or more of the following:

1. Already existing City practice,
2. Covered under or linked with another existing strategy on the Master Strategy List,
3. Limited by a state or legal barrier,
4. Framed as a non-structural deficit option ( i.e., does not have a direct or ongoing dollar impact on the General Fund).

Many other ideas were identified as new and were categorized against the qualification and disqualification criteria used throughout this project, and added to the Master Strategy List.

Overall, employee survey responses indicated more openness for ways to increase revenue and some service delivery changes while the greater San José community shows greater support for expenditure controls/shifts and much less for revenue generation. Both groups appear not to support service reductions and most strongly for street and park maintenance. The same categories were indicated by both groups of survey respondents as areas in which the City spent “too little.” These are probable results after the recent years of reductions San José has experienced. In addition, both groups continue to view public safety as a first priority for the City.

## **BENCHMARKING RESULTS**

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The use of benchmarking to analyze and compare San José with peer jurisdictions is useful to determine how the City is operating and to serve as a broad point of comparison. Although helpful, benchmarking data should be used carefully. Whenever data from individual city budgets is used for comparison purposes, some format and presentation differences may hamper valid comparisons. Consequently, Management Partners has taken care in drawing firm conclusions from the data.

The following factors are important to consider when weighing the value of peer comparisons:

- Every city is unique and attempts to compare are always imprecise.
- Reporting standards, particularly with respect to the definition of special funds, designated funds and reserve funds, can vary greatly.
- The data is most useful for illuminating averages, the polar opposites from the average, and where San José places on the scale. Further research would be necessary to make any definite findings between peer city "X" and the City of San José.
- Benchmarking provides data to assist in the management decision making process; it is not meant to "grade" a city or to create resource allocation formulas.
- The quantitative benchmarking completed in this analysis does not always identify process differences that can substantially impact resource needs. Some process benchmarking may be a logical follow-up in areas where significant quantitative variances are apparent.

Nevertheless, the data contains many insights and explanations that will help in identifying peer and nominal or "market" levels for revenues as well as expenditures. More importantly, the results shed some light on the budget decisions the City has to make and the balancing of resource allocations inherent in the budget process.

At the beginning of the review, the City agreed on the jurisdictions to be used as benchmarking peers. As previously indicated, the list included the 10 largest cities in California, plus the City of Fremont which was the only other "top 20" city located in the Bay Area. In addition, to provide some regional comparisons, a number of cities in Santa Clara County

were included in the peer analysis. The peer cities, and corresponding populations are included in Table 7 below.

**TABLE 7: PEER JURISDICTIONS AND POPULATIONS**

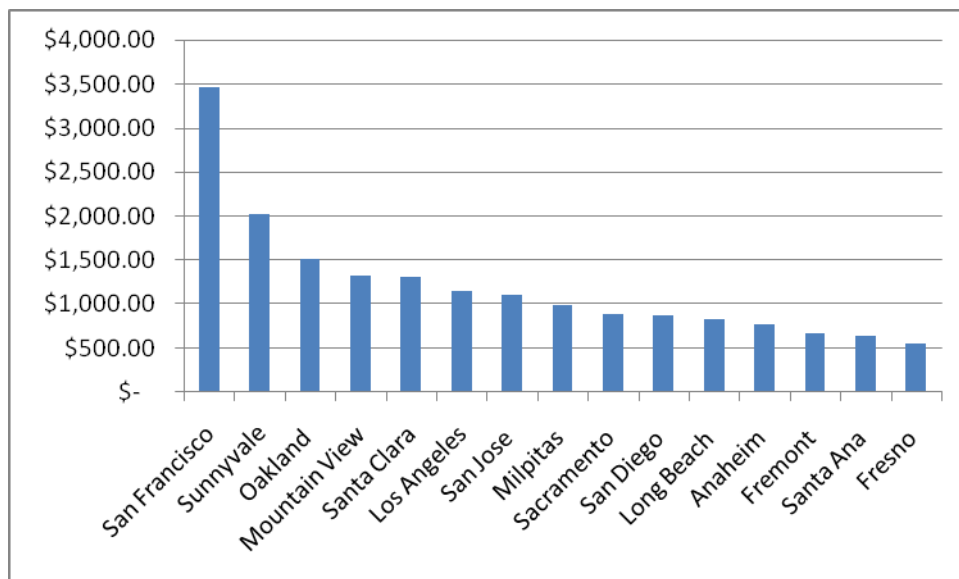
<b>Jurisdiction</b>	<b>Population</b>
Anaheim	345,317
Fremont	210,445
Fresno	464,727
Long Beach	491,564
Los Angeles	3,957,875
Milpitas	65,049
Mountain View	72,242
Oakland	412,318
Sacramento	452,959
San Diego	1,305,736
San José	944,857
San Francisco	799,263
Santa Ana	351,697
Santa Clara	109,106
Sunnyvale	133,983

San Francisco has been included as a peer but because of its unique status as a city and county, some revenue and expenditure comparisons can be skewed.

Information from publicly available sources was gathered from the various jurisdictions which resulted in the benchmark results shown in the following section.

Figure 5 shows General Fund revenues per capita among the peer jurisdictions.

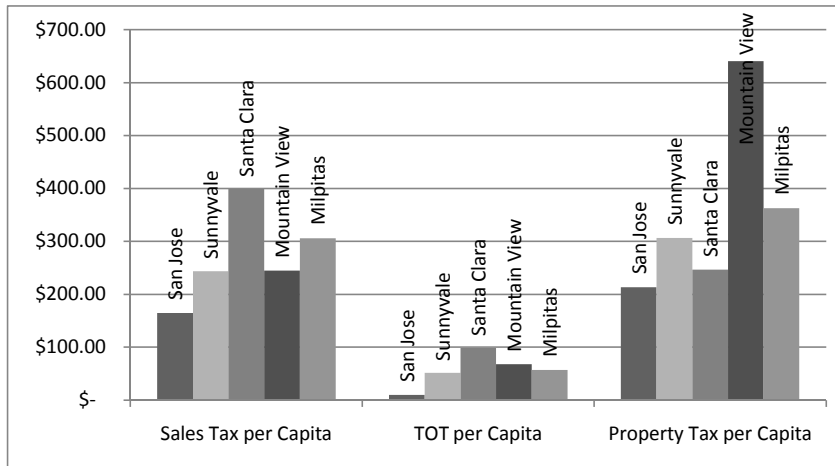
**FIGURE 5: TOTAL GENERAL FUND REVENUES PER CAPITA**



San José has only average revenues per capita when compared with other large cities. It has among the lowest revenues per capita of major cities in the Bay Area.

As shown in Figure 6, San José lags behind other Santa Clara County cities in many basic General Fund tax revenues per capita. San José is the lowest for Sales Tax Per Capita, Transit Occupancy Tax (TOT) Per Capita, and Property Tax Per Capita.

**FIGURE 6: SAN JOSÉ LAGS OTHER SANTA CLARA COUNTY CITIES IN MANY BASIC GENERAL FUND TAX REVENUES PER CAPITA**





Major tax rates and revenue per capita are detailed in the Table 8 below.

**TABLE 8: REVENUE SOURCES PER CAPITA FY 2008**

FY 07/08 Revenues per Capita									
	Sales Tax per Capita	Rate	TOT per Capita	Rate	Utility Tax per Capita	Rate	Conveyance Tax per Capita	Rate per \$1000	Business License per Capita
<b>State Wide Peers</b>									
Los Angeles	\$ 90.64	8.25%	\$ 37.41	14.0%	\$ 162.94	10.0%	\$ 40.79	\$ 4.50	\$ 124.07
San Diego	\$ 190.54	7.75%	\$ 66.35	10.5%	N/A	N/A	\$ 60.46	\$ 0.55	\$ 15.88
<b>San Jose</b>	<b>\$ 164.14</b>	<b>8.25%</b>	<b>\$23.70</b>	<b>10.0%</b>	<b>\$ 85.43</b>	<b>5.0%</b>	<b>\$ 29.03</b>	<b>\$ 3.30</b>	<b>\$ 25.92</b>
San Francisco	\$ 139.56	8.50%	\$ 180.92	14.00%	\$ 63.81	7.50%	\$ 154.54	\$6.80; above 1 million \$7.50	\$ 451.11
Long Beach	\$ 83.47	8.25%	\$ 30.11	12.0%	\$ 91.12	5.0%	\$ 158.46	\$ 0.55	\$ 24.47
Fresno	\$ 46.11	7.975%	\$ 23.38	12.0%	N/A	N/A	\$ 4.50	\$ 0.55	\$ 35.27
Sacramento	\$ 157.56	7.75%	\$ 7.27	12.0%	\$ 131.65	7.5%	\$ 19.83	\$ 0.55	\$ 16.31
Oakland	\$ 152.60	8.75%	\$ 31.14	11.0%	\$ 131.41	7.5%	\$ 169.28	\$ 15.00	\$ 120.68
Santa Ana	\$ 137.57	7.75%	\$ 21.99	9.0%	\$ 84.34	6.0%	\$ 3.82	\$ 0.55	\$ 28.26
Anaheim	\$ 216.60	7.75%	\$ 248.33	15.0%	N/A	N/A	\$ 6.45	\$ 0.55	\$ 17.51
Fremont	\$ 139.34	8.75%	\$ 15.97	18.0%	N/A	N/A	\$ 8.41	\$ 0.55	\$ 34.70
<b>AVERAGE</b>	<b>\$ 138.01</b>	<b>8.16%</b>	<b>\$ 62.42</b>	<b>12.50%</b>	<b>\$ 107.24</b>	<b>6.93%</b>	<b>\$ 59.60</b>	<b>\$ 2.67</b>	<b>\$ 81.29</b>
<b>Local Peers</b>									
Sunnyvale	\$ 243.20	8.25%	\$ 51.11	8.50%	\$ 48.74	2.00%	\$ 37.32	\$ 0.55	\$ 8.21
Santa Clara	\$ 398.36	8.25%	\$ 98.18	10.00%	N/A	2.00%	\$ 8.25	\$ 0.55	\$ 7.52
Mountain View	\$ 244.51	8.25%	\$ 67.61	10.00%	N/A	N/A	\$ 6.81	\$ 0.55	\$ 3.88
Milpitas	\$ 305.89	8.25%	\$ 56.88	10.00%	\$ 87.63	3.00%	\$ 30.75	\$ 3.30	\$ 3.38
<b>AVERAGE</b>	<b>\$ 297.99</b>	<b>8.25%</b>	<b>\$ 68.44</b>	<b>9.63%</b>	<b>\$ 68.18</b>	<b>2.33%</b>	<b>\$ 20.78</b>	<b>\$ 1.24</b>	<b>\$ 5.75</b>

The City of San José is well below its statewide and local peers for Transit Occupancy Tax (TOT). When compared with its statewide peers, San José is also well below in Conveyance Tax and Business License revenues. San José Sales Tax per capital is lower in comparison to their local peers.

The low TOT per capita total is a partial result of the lower rate of 10% which is below the average rate of 12.5% for the statewide peers. Another reason why San José is lower than its peers is also a result of

the demographic differences between San José and cities such as Anaheim, with Disneyland and San Francisco, as an international tourist “hot spot.” But San José is not a peer of cities like Fresno and Fremont who generally do not have robust tourism or convention visitors.

The low Utility Users Tax (UUT) can be attributed to both its low rate of 5.0% (compared with an average of 6.93% for statewide peers) and the fact that the tax covers a limited number of utilities. At present, it covers electricity, gas, water and telephone but does not include interstate and international telephone, internet access or cable television.

The Business License revenue in San José is also unique when examining peers. San José is in line with its local peers, but is not on a statewide basis. A strong argument could be made that the local peers are not appropriate comparisons for San José. San José is the largest city in Santa Clara County and like many of its statewide peers, is the urban core of a given geographical area.

Table 9 below shows a comparison of Sales Tax, TOT, Conveyance Tax, UUT rates, and Business Tax administrative fees among the peer cities. As can be seen, San José is below average for TOT and UUT rates, and quite low in the percentage of TOT transferred to the General Fund. Of the 15 peers, only the cities of San José and Mountain View do not allocate their Conveyance Tax revenue to their respective General Funds.

**TABLE 9: PEER COMPARISON OF TAX RATES AND GENERAL FUND ALLOCATIONS**

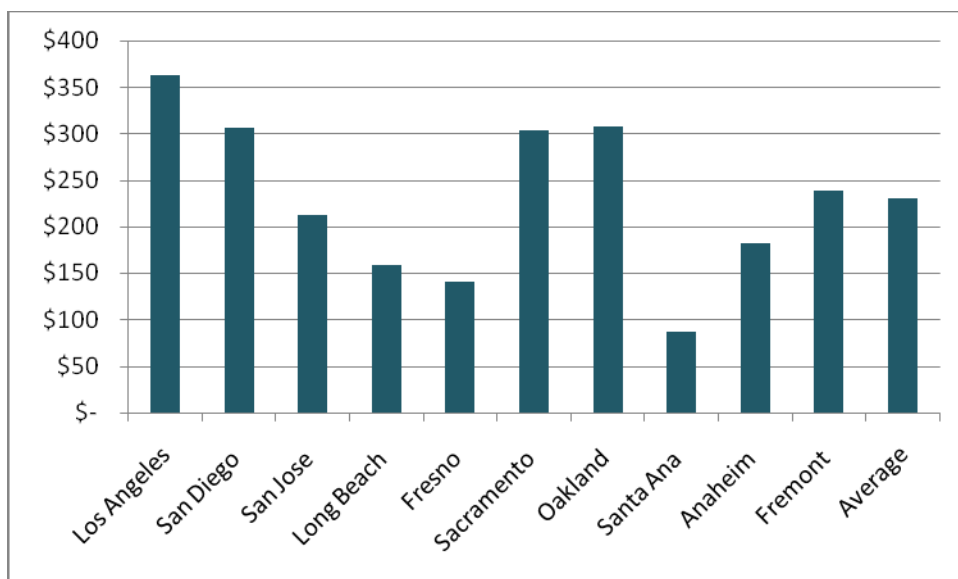
Tax Rates and General Fund Allocations							
City	Sales Tax Rate	Transient Occupancy Tax	Transient Occupancy Tax Percentage to GF	Real Property Transfer Tax Rate per \$1000 Property Value	Conveyance Tax to GF	Utility Tax Rates	Business License Admin Fees
Los Angeles	8.25%	14.00%	14.00%	\$ 4.50	100.00%	10.00%	none
San Diego	7.75%	10.50%	5.50%	\$ 0.55	100.00%	n/a	\$ 25 (\$10 renewal)
<b>SAN JOSE</b>	<b>8.25%</b>	<b>10.00%</b>	<b>4.00%</b>	<b>\$ 3.30</b>	<b>9.78%</b>	<b>5.00%</b>	<b>none</b>
<b>San Francisco</b>	8.50%	14.00%	varies	\$6.80; above 1 million \$7.50	100.00%	7.50%	none
Long Beach	8.25%	12.00%	6.00%	\$ 0.55	100.00%	5.00%	none
Fresno	7.975%	12.00%	12.00%	\$ 0.55	100.00%	n/a	\$ 10.00
Sacramento	7.75%	12.00%	2.00%	\$ 0.55	100.00%	7.50%	none
Oakland	8.75%	11.00%	11.00%	\$ 15.00	100.00%	7.50%	\$ 30.00
Santa Ana	7.75%	9.00%	9.00%	\$ 0.55	100.00%	6.00%	none
Anaheim	7.75%	15.00%	15.00%	\$ 0.55	100.00%	n/a	none
Fremont	8.75%	8.00%	8.00%	\$ 0.55	100.00%	n/a	\$ 30.00
<b>STATE WIDE PEER AVERAGE</b>	<b>8.16%</b>	<b>11.59%</b>	<b>8.65%</b>	<b>\$2.67-\$3.10</b>	<b>91.80%</b>	<b>6.93%</b>	<b>\$ 23.33</b>
Sunnyvale	8.25%	8.50%	8.50%	\$ 0.55	100.00%	2.00%	\$56 (renewal \$23)
Santa Clara	8.25%	10.00%	10.00%	\$ 0.55	100.00%	n/a	none
Milpitas	8.25%	10.00%	8.00%	\$ 0.55	100.00%	n/a	\$ 50.00
Mountain View	8.25%	10.00%	10.00%	\$ 3.30	0.00%	3.00%	none
<b>LOCAL PEER AVERAGE</b>	<b>8.25%</b>	<b>9.63%</b>	<b>9.13%</b>	<b>\$ 1.24</b>	<b>75.00%</b>	<b>2.50%</b>	<b>\$ 53.00</b>

The following figures highlight specific revenue sources and how San José compares with its statewide peers. It should be noted that the unique status of San Francisco as both a city and county can make it an

outlier and skews averages. The Sales Tax, UUT, and Business License Administrative fees are all General Fund revenues.

In Figure 7 below, property tax revenues per capita are shown. San Francisco has been eliminated from this graph to improve legibility. As both a city and a county San Francisco receives a higher proportion of property tax revenues (over \$1400 per capita) than other cities, but has greater service obligations. San José is below its peer average for property tax per capita whether San Francisco is included or not.

**FIGURE 7 : PEER COMPARISON OF PROPERTY TAX REVENUES PER CAPITA**



The figure below highlights that San José has about average sales tax revenues per capita.

**FIGURE 8: PEER COMPARISON OF SALES TAX PER CAPITA**

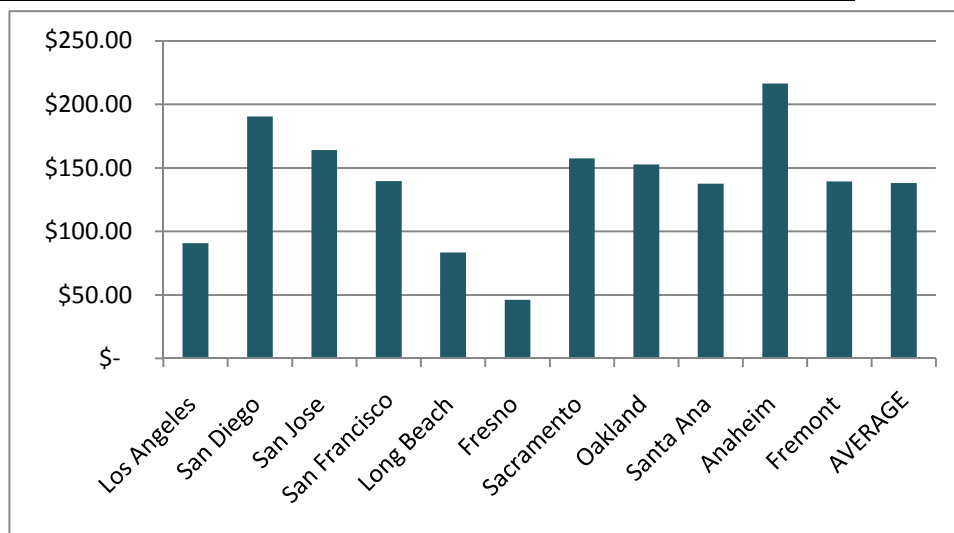
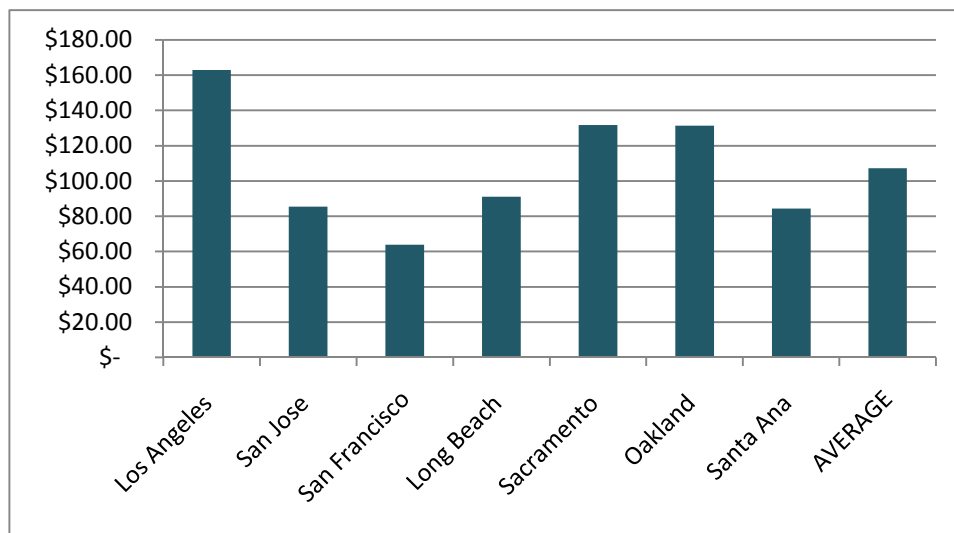


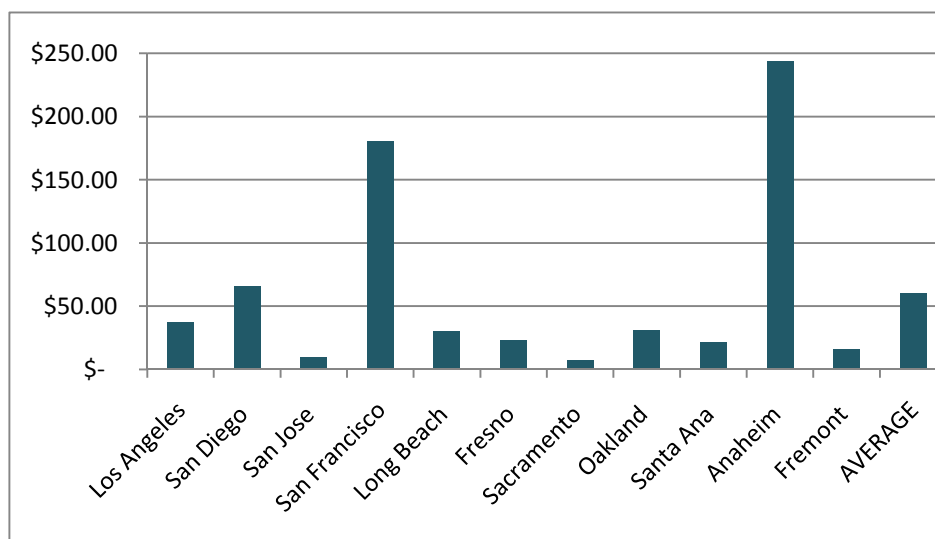
Figure 9 below shows San José as below average compared with its peers for UUT revenue (just under 80% of statewide peer average).

**FIGURE 9: PEER COMPARISON OF UTILITY TAX PER CAPITA**



When examining the TOT revenue per capita, it should be noted that San Francisco and Anaheim are unique travel destinations that have resulted in both a higher TOT rate and revenue per capita. But even if the cities were factored out of the analysis, the City of San José is well below its peers in TOT revenue per capita. Figure 10 shows this comparison.

**FIGURE 10 PEER COMPARISON OF TRANSIENT OCCUPANCY TAX PER CAPITA**



Again, for business tax per capita, the City/County of San Francisco skews the statewide peer average and it has been removed from this comparison to improve legibility. San Francisco has over \$400 per capita in business tax revenues due to its unique income tax based levy. Figure 11 shows this comparison.

**FIGURE 11: PEER COMPARISON OF BUSINESS TAX PER CAPITA**

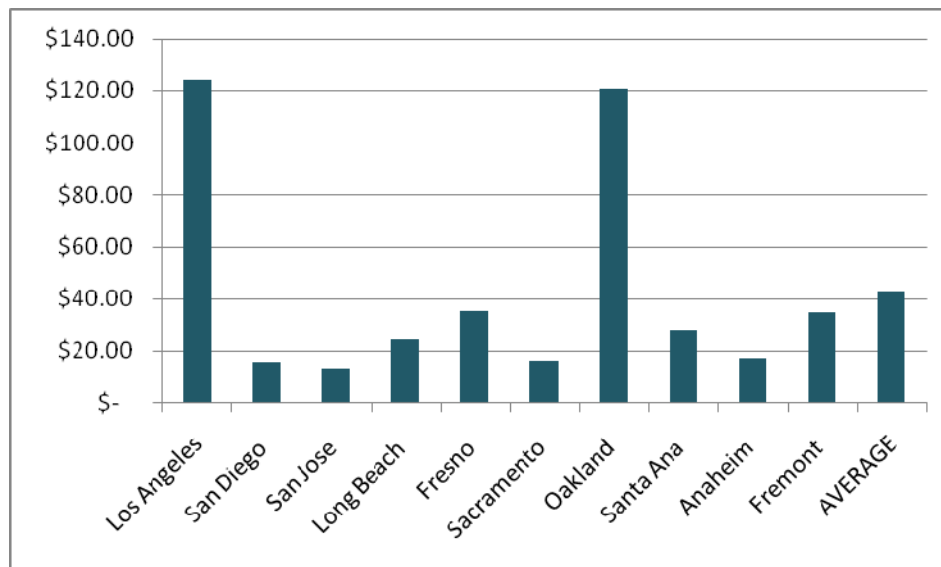


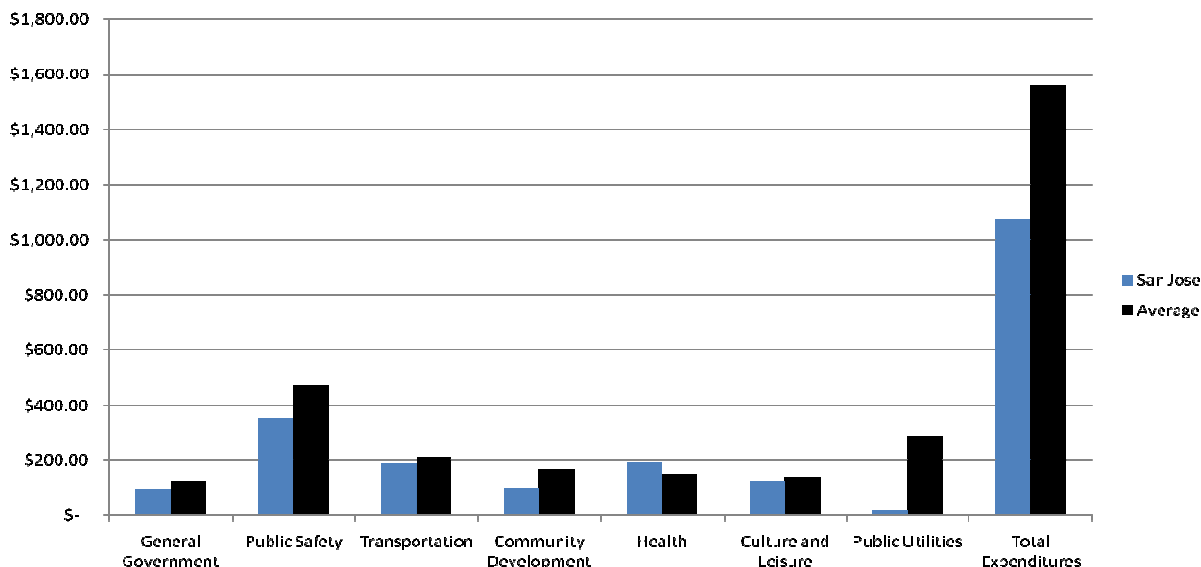
Table 10 below shows the comparison of real property transfer tax rates and transfers to the General Fund. As can be seen, while the rate being charged is above average, the City transfers a very limited amount of these revenues to the General Fund, as compared with an average of over 90% transferred by peer cities.

**TABLE 10: PEER COMPARISON REAL PROPERTY TRANSFER TAX (CONVEYANCE TAX)  
COMPARISON OF PEER JURISDICTIONS**

Los Angeles	\$ 4.50	100.00%
San Diego	\$ 0.55	100.00%
<b>SAN JOSE</b>	<b>\$ 3.30</b>	<b>9.78%</b>
San Francisco	\$6.80; above 1 million \$7.50	100.00%
Long Beach	\$ 0.55	100.00%
Fresno	\$ 0.55	100.00%
Sacramento	\$ 0.55	100.00%
Oakland	\$ 15.00	100.00%
Santa Ana	\$ 0.55	100.00%
Anaheim	\$ 0.55	100.00%
Fremont	\$ 0.55	100.00%
<b>STATE PEER AVERAGE</b>	<b>\$2.67-\$3.10</b>	<b>91.80%</b>
Sunnyvale	\$ 0.55	100.00%
Santa Clara	\$ 0.55	100.00%
Milpitas	\$ 0.55	100.00%
Mountain View	\$ 3.30	0.00%
<b>LOCAL PEER AVERAGE</b>	<b>\$ 1.24</b>	<b>75.00%</b>

Figure 12 below compares expenditures per capita compared with San José's large city peers; it does not contain peer information from the City/County of San Francisco. As previously stated, San Francisco is a unique peer. When examining expenditures in particular, Management Partners determined that San Francisco would not be an appropriate expenditure comparison for San José.

**FIGURE 12: EXPENDITURES PER CAPITA COMPARED WITH LARGE CITY PEERS**



Relative to other peer cities, San José has low to average per capita revenues and expenditure levels. Expenditure data indicates that San José spending is not atypical for large cities in California.

Most notable, tax allocations to the General Fund similar to that in other cities would have a major positive financial impact for the City. While revenues are there, the transfer out of the General Fund is much greater than seen elsewhere. While these policy designations undoubtedly made sense when originally made, the passage, court decisions, and City Attorney opinions concerning California's Proposition 218 (the Right to Vote on Taxes Act) have had the impact of "hardening" the allocation to a matter of law, not just a policy determination by the City Council.

Staffing was another point of an overview comparison with the peer jurisdictions. As one would expect given the expenditure data, San Jose does not exhibit a high level of staffing per capita. This is shown in Table 11 below. Adjustments were made for service level variation among the cities.



**TABLE 11: CITY STAFFING PEER CITY COMPARISON 2007-08**

City	Population	FTE	Adjusted FTE	Adjusted FTE per 1,000 Population
Anaheim	334,425	2,150	1,788	5.35
Fremont	201,691	912	912	4.52
Fresno	466,714	4,125	4,125	8.84
Long Beach	472,494	5,853	4,907	10.38
Los Angeles	3,849,378	33,898	33,588	8.73
Oakland	397,067	4,390	4,339	10.93
Sacramento	453,781	4,142	4,005	8.83
San Diego	1,256,951	10,764	8,996	7.16
<b>San José</b>	<b>973,672</b>	<b>6,992</b>	<b>6,992</b>	<b>7.18</b>
Santa Ana	340,024	1,753	1,753	5.16
<b>Average</b>	<b>874,620</b>	<b>7,498</b>	<b>7,140</b>	<b>7.71</b>

The peer cities chosen are the largest in the state and have differing functions that require different staff levels. To create a more equal comparison, an adjusted full-time equivalent (FTE) number was calculated by Management Partners. Specifically, each general city service area was compared with the City of San José and FTEs were eliminated for any services not offered by San José. Some examples of eliminated groups include the City of Los Angeles' Commission on the Status of Women, Long Beach Harbor Department and Anaheim's electric utility. San Francisco was eliminated from the comparison due to the county functions it provides and the difficulty of adjusting for this factor.

Using this methodology, the number of FTE per 1,000 population for the City of San José is below average at 7.18 FTEs. The average of all peers is 7.71.

Generally the benchmarking analysis illuminates several important factors shaping the San José budget situation:

- San José is below the market rate for business tax and transient occupancy tax, especially compared to large city peers.
- San José is about average for sales and property tax revenues, relative to big city peers but below the levels in surrounding cities.
- San José is somewhat below average for utility tax revenues for cities with this tax.
- San José is about average for conveyance tax, but the tax is far more common in the Bay Area than in other areas of the state, and many cities in the area are higher than San José.
- San José allocates "General Purpose" tax revenue to Special Funds more than other cities.



## **BEST PRACTICES RESULTS**

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As noted, part of the analysis was to evaluate best practices utilized in other top performing municipalities. This analysis confirmed that San José is already utilizing most of the best practices utilized in California. Because of the limitations in state law, approaches taken in other states are not always possible in California.

In particular San José is ahead of the curve in terms of recognizing currently unfunded liabilities and formulating strategies to address this issue (which is the most important factor now facing local government, and indeed all government in California). The fact that San José began to address the structural deficit problem well in advance of the recently announced state budget deficit also is indicative of the priority the City places on insuring budget integrity.

Nevertheless, our review of best practices in other jurisdictions did net some findings that can be of benefit to San José. These are discussed in more detail in the strategy analysis sections themselves. Some of the areas where best practice observations are helpful for San José include:

1. Development of stronger asset management policies to ensure that City assets are measured at market value and managed to benefit the overall corporate mission of the City.
2. Utilization of managed competition programs, such as those used in San Diego County to compare city service delivery costs against appropriate private sector benchmarks.
3. Ongoing use of service optimization studies, such as those practiced in Long Beach that ensures fees and charges fully cover city costs.



## **MOVING FROM INITIAL STRATEGIES TO TOP PRIORITY STRATEGIES**

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The original strategies list, combined with stakeholder and employee survey input as well as benchmarking and best practices research results, resulted in a comprehensive list of 320 potential strategies for reducing the General Fund budget deficit.

Management Partners, in collaboration with the City Manager's Task Force, prepared specific criteria against which to screen these 320 strategies. Through this screening process, top priority strategies for further analysis clearly emerged.

Strategy qualification criteria were:

1. Preliminary benchmarking information shows that San José is below market (revenues) or above market (expenditures).
2. Strategy is being used in a best practice jurisdiction or another of the peer jurisdictions.
3. Prior work by budget office or other City department has made a convincing argument for change.
4. Practice is out of alignment with current City objectives or planning.

Strategy disqualification criteria were:

- A. Strategy cannot be effectively implemented in a three-year time frame.
- B. Strategy would not reduce deficit or if it does would have greater longer run costs.
- C. Strategy is not consistent with the current Council's three year goals.
- D. Strategy would have a limited impact, and cannot be logically aggregated with similar strategies.

This screening process resulted in just 194 of the 320 suggested strategies qualifying for some level of further analysis. Of the 106 strategies that did not qualify, many are good ideas but realistically could not be implemented in three years and should be placed on the City's long-term work plan for further review and potential implementation.

With a list of over 194 qualified strategies in hand, Management Partners prioritized them based upon dollar value to the City and implementation

potential. Some smaller scale strategies were recognized as having potential to be aggregated to meaningful levels, e.g., cost recovery done for single services that would result in a minor budget improvement can be sizeable if addressed City-wide.

Management Partners held a second series of meetings with stakeholders groups at the end of November 2007 to review the preliminary list of top strategies. Each strategy was further analyzed in detail by calculating revenue and expenditure estimates; assessing implementation considerations, costs, and timeframes; and comparing against benchmarks and best practices.

In the end, 21 broad based strategies were selected as the most viable to be implemented in the three-year window and to make significant progress in reducing and eliminating the structural deficit in the City's General Fund. On the low end, a combination of these strategies could have a positive fiscal impact of \$115 million and on the high end \$218 million. This report details each of those strategies.

## **CITY MANAGER'S TASK FORCE TOP PRIORITY STRATEGIES**

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Throughout the process of identifying and qualifying possible budget deficit reduction strategies, the City Manager's General Fund Structural Deficit Task Force met and discussed the options. The meetings helped identify feasible strategies with significant fiscal impact and allowed input from various departments within the City. In addition, Management Partners met with many of the Task Force members in separate one-on-one interviews to discuss particular strategy options relevant to their departments and areas of expertise within the City.

At the final Task Force meeting, Management Partners created a list of top strategies and their fiscal impacts for the Task Force members to discuss. The list was a result of six to eight strategies each for the three major categories of priorities chosen by two factors: priority ranking from the second round of stakeholder group meetings and their fiscal impact. (It should be noted again that the Service Reductions category will be developed as part of the 2008-2009 Proposed Budget process.) The Task Force then had an opportunity to prioritize this list of strategies to be presented in this report.

Management Partners used a variety of tools and assumptions to estimate the fiscal impact of various strategies. The strategy discussions provide more complete detail as well as the individual estimates generated. Generally, the approach was to conservatively scale savings estimates based on documented observations from other cities and/or to rely on conservative estimates generated from City staff analysis. One key rule followed in estimating fiscal impact was to rely on actual demonstrated practices in other jurisdictions. With a few relatively minor exceptions, all the suggestions offered for San José are utilized in another comparable setting.

Table 12 below lists the top strategies in the priority order:

**TABLE 12: LIST OF TASK FORCE TOP STRATEGIES (IN PRIORITY ORDER) BY TYPE**

<b>Revenue Strategies</b>	<b>Fiscal Impact (in millions)</b>
1. Extend Emergency Communication System Support Fee	\$23.4
2. Utilize Financing Strategies which have Positive Net Present Value	\$1.7 to \$6.1
3. Ensure Current Fees Fully Cover All City Costs	\$2 to \$9
4. Restructure Business Tax Rates to Modernize and Reflect Current Business Profile	\$6.3 to \$15
5. Modernize Utility Users Tax and Consider Bringing the Rate into Alignment with other Large Cities having this Tax	\$7.9 to \$39.6
6. Implement City-Wide Lighting and Landscape Districts or other Proposition 218 "Property Related" Fees	\$2.5 to \$11
7. Levy Parcel Tax or Sales Tax for Public Safety or Other Services	\$14 to \$38
8. Increase Transient Occupancy Tax to Market and Shift to General Fund	\$4.5 to \$11.3
<b>Service Delivery Model Changes:</b>	<b>Fiscal Impact</b>
1. Formalize and Implement a Rigorous Asset Management Program	\$3.3 to \$5.0
2. Combine Redevelopment and City Corporate Support Functions and Shift Economic Development Costs to Maximum Extent Possible	\$5.4
3. Revise Competition Policy, Implement Managed Competition for Service Delivery, and Optimize Work Processes	\$8 to \$13.3
4. Increase Use of Civilian Positions in Police and Fire	\$0.5 to \$1.5
5. Eliminate Binding Interest Arbitration	Future Cost Avoidance
6. Modify Minimum Fire Staffing Policies Where Appropriate Based on Fire Strategic Plan	Dollar impact to be determined
7. Implement an Employee Suggestion and Process Streamlining Program	Up to \$1



<b>Expenditure Controls and Shifts</b>	<b>Fiscal Impact:</b>
1. Shift Healthy Neighborhood Venture Fund Funding to General Fund	\$5 to \$9
2. Reduce Worker's Compensation, Disability and Overtime Costs	\$3.0 to \$4.2
3. Shift Construction and Conveyance Tax Funding from Capital Projects to Operating and Maintenance Costs	\$6 to \$12
4. Reduce the Rate of Increase in Employee Salary and Benefit Costs	\$6.6 to \$10
a. Increase Time to Reach Maximum Compensation	\$1.9
b. Reduce Entry Level Compensation for Positions for which the City Receives Many, Qualified Applicants	\$0.7 to \$1.7
c. Implement Health Care Plan Modifications	\$1.2 to \$4.6
d. Implement Sick Leave Payment Modifications on Retirement	\$1.8
5. Change Prevailing Wage Applications: Eliminate Service Contracts	\$1.2
<b>Service Reductions</b>	<b>Fiscal Impact</b>
1. Reduce/Eliminate City Services to Funding Capacity	\$25

Another Service Delivery Model Change strategy has been proposed, but the City Manager's Task Force did not discuss it, that being "Implement an Employee Suggestion and Process Streamlining Program.

The City Manager's Task Force did choose to remove one previously included Expenditure Controls and Shifts strategy. The strategy was "adopt a two-tier retirement program." The City Manager's Task Force felt the strategy could not be accomplished within a three year timeframe although they agreed the strategy could be effective. Instead of disqualifying it entirely, they asked it be moved to a long-term strategy category in the current report.

## Overview of Top Priority Strategies for Further Consideration

The following strategies are presented for potential adoption by the City to reduce or eliminate the General Fund structural deficit within the next three fiscal years. Each strategy below has been screened and passes the established "qualification/disqualification criteria," and Management Partners has performed additional research to estimate projected fiscal

and operational impacts. In some cases the strategy may contain numerous and discrete sub-strategies that have been suggested during the strategy development process. For example, the strategy of increasing City user fees and other charges to fully cover costs includes literally dozens of potential fee adjustments. The same is true for several other strategies.

As noted earlier, all strategies have been separated into three distinct categories:

- Revenue Strategies
- Service delivery Model Changes
- Expenditure Controls and Shifts

Another strategy category, "Service Reductions," is being more fully developed as part of the City budget process. As mentioned previously in the report, it was determined that the process of evaluating potential service reductions is best addressed as a part of the City's budgetary process. It is anticipated that approximately \$25 million in structural budget reductions will be achieved from this strategy and City Service Areas and departments are developing recommendations for this strategy.

For consideration are strategies which are generally City-wide in scope rather than program oriented. The expectation is that service reductions to existing programs will be part of the overall structural budget deficit solution through the annual budget process as described above.

As part of the strategy analysis, Management Partners has drawn on expertise from within the City, from the experience of other peer and best practice jurisdictions, and from our experience working with cities and counties throughout the United States. Each strategy is feasible at some level within San José and either is or has been used in other similar municipal service settings. Of course, the ultimate applicability to San José will be a matter for the policy decision makers after obtaining more input and receiving additional analysis.

While the analysis to date on these strategies has been significant, it is not yet sufficient to support final determinations. No broad-based 90-day effort involving as complex an organization as the City of San José could hope to provide all the answers. Nevertheless the discussion of strategies that follows will allow City decision makers to chart a feasible course for eliminating the structural budget deficit within the next three years. It will take several additional months of dedicated effort and further analysis to actually fashion a plan, and years to fully implement the solutions. This is a starting point.

The full list of strategies that have been suggested can be found as Attachment A to this report.

## **Revenue Strategies**

### **An Overview of City Revenue Sources**

City revenues come from a variety of sources. Some are restricted to certain uses by law. Some revenues are payment for a specific service by customers. Other revenues require voter approval for rate increases. Still other revenues come from state and federal agencies, and the City has no control over how much it receives. The California Constitution and state law provide some specific distinctions among municipal revenue sources. The following provides a very brief summary of major revenue sources adapted from the League of California Cities "Primer on California City Finance" by Michael Coleman.

### ***Taxes***

A tax is a charge for public services and facilities. There need not be a direct relationship between the services and facilities used by an individual taxpayer and the tax paid. Cities may impose any tax not otherwise prohibited by state law. The California Constitution distinguishes between a general tax and a special tax. General tax revenues may be used for any purpose. A majority of voters must approve a new general tax, its increase or extension in the same election in which city council members are elected. Special tax revenues must be used for a specific purpose, and two-thirds of voters must approve a new special tax, its increase or extension.

### ***Charges and Assessments***

A fee is a charge imposed on an individual for a service that the person chooses to receive. A fee may not exceed the estimated reasonable cost of providing the particular service or facility for which the fee is charged, plus overhead. Examples of city fees include water service, sewer service connection, building permits, recreation classes and development impact fees.

Cities have the general authority to impose fees under the cities' police powers granted by the state Constitution. There are specific procedures in state law for fee and rate adoption. Proposition 218 provides special rules for property-related fees used to fund property-related services. Special benefit assessments are charges levied to pay for public improvements or services within a predetermined district or area, according to the benefit the parcel receives from the improvement or services. The state Constitution requires property-owner approval to impose a benefit assessment. Other locally raised revenues include licenses and permits; franchises and rents; royalties and concessions, fines, forfeitures and penalties; and investment earnings.

### ***Intergovernmental Revenue***

Cities also receive revenue from other government agencies, principally the state and federal governments. These revenues include general or categorical support monies called subventions, as well as grants for specific projects, and reimbursements for the costs of some state mandates.

### ***Other City Revenues***

Other sources of revenue to cities include rent, concessions and royalties; investment earnings; revenue from the sale of property; proceeds from debt financing; revenues from licenses and permits; and fines and penalties. Each type of revenue has legal limitations on what may be charged and collected as well as how the money may be spent.

One of the methods to improve the structural deficit is to increase revenues. The following strategies have been identified as the top priority strategies to increase City revenues.

#### **1. Extend Emergency Communication System Support Fee (\$23.4 million)**

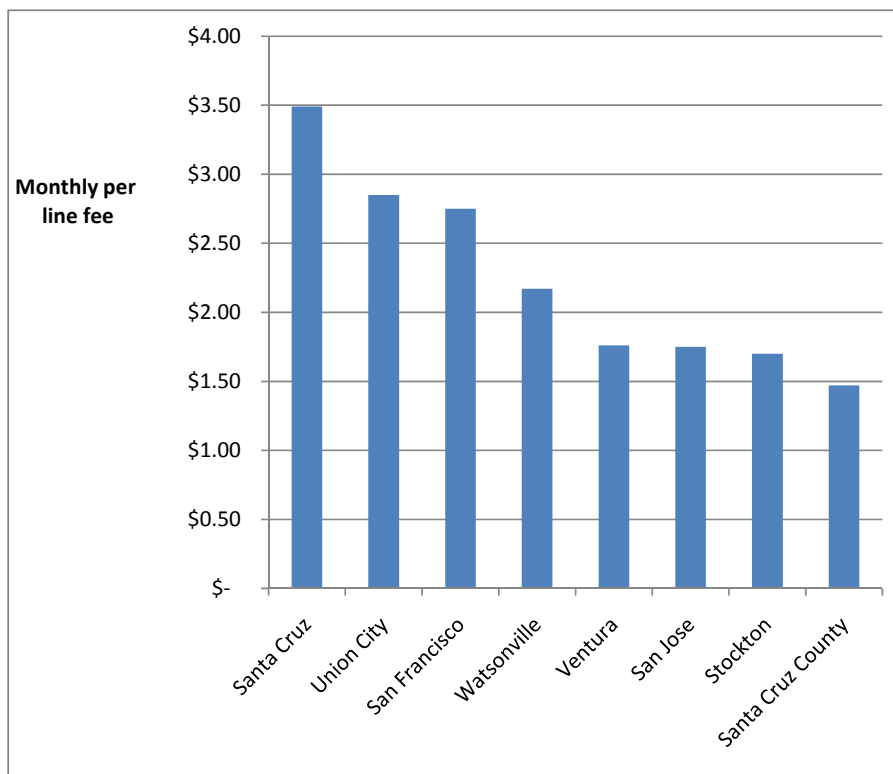
On August 17, 2004, the City Council approved an ordinance to establish an Emergency Communication System Support (ECSS) fee to pay for the operation of the City's Emergency Communications Center (ECC). This ordinance required a small monthly fee from most telephone customers (\$1.75 per line) to help fund the City's 911 emergency dispatch services. The fee is charged on most personal and business telephone lines and cell phones in the City. Some exemptions exist, mainly relating to customers on lifeline service and service to non-profits and government offices. The City estimates that approximately 90% of the phone accounts in the City are taxed. The justification for charging a fee to telephone subscribers is that only people who have telephones can call 911 for emergency services. As stated in the ordinance, "Subscribers to telephone service derive significant benefits from ongoing operation of the modernized integrated system installed at the San José Emergency Communications Center" in the form of more efficient dispatch of services to a 911 emergency request.

The ECSS fee ordinance was to expire on December 31, 2006. On June 20, 2006, the San José City Council approved City Ordinance No. 27785 to extend the fee through June 30, 2009. It should be noted that prior to extending the fee, the Office of Economic Development conducted several outreach efforts to businesses and no major opposition was voiced regarding the fee.

Fees of this nature (often known as "911 fees") have become relatively common in California since the first such fee was established in San Francisco in the early 1990s. Such fees are particularly common in the Bay Area. San José's fee is typical and the charge is about average for this area.

Figure 13 below shows the ECSS fee imposed (or proposed) in several California cities. As can be seen, the cities of Santa Cruz, Union City and San Francisco all charge considerably more than San José.

Figure 13: ECSS Fees in Benchmark Cities



The ECSS fee generates approximately \$23 million per year for the City and offsets 88% of the costs associated with operation of the 911 dispatch center. As noted, the fee is slated to sunset in 2009 and, therefore, the potential loss of this revenue represents a significant part of the structural deficit.

Because the ECSS is a user fee it can be continued by a vote of the City Council. However, some telecommunications companies have asserted that the fee is, in fact, a special property related fee and therefore should be subject to voter approval. The issue is currently under litigation in several cities, including Stockton and Union City. To date, the fee is not the subject of litigation in San José.

Santa Cruz County successfully defended a challenge to its fee, although the opinion was not published. Legal observers expect that phone companies will continue the litigation strategy in hopes of getting a published opinion that these fees are property related and require a vote.

The ECSS fee is a crucial revenue source to the City of San José. It is common and reasonably well accepted by the public (phone companies

excepted). San José does a good job of segregating the fee funding for the 911 dispatch center only and does not pay all system costs with the fee proceeds.

While local government should be aware of the potential litigation risk associated with the fee, so far no litigation has been successful and all the local governments with this fee are continuing it. Indeed, the County of Santa Clara just adopted such a fee while fully aware of the ongoing litigation in other areas. San José should keep this revenue source and, only if necessary, place the matter before the voters if there is a published opinion specifying that the fee must be considered a property related fee.

## **2. Utilize Financing Strategies which have Positive Net Present Value (\$1.7 to \$6.1 million)**

The City of San José enjoys a strong credit rating because it manages funding carefully and uses debt financing in a prudent manner. Because of this strong credit rating and the generally solid condition of the City's reserve funds there are two suggested opportunities to generate annual savings on City pension contributions: 1) a modest issuance of pension obligation bonds (POBs); and 2) full pre-payment of annual employer pension contributions at a discount, possibly coupled with issuance of Tax and Revenue Anticipation Notes (TRANS).

Both of these strategies take advantage of the significant difference between the time horizon and investment options for pension funds and for City surplus funds. State law restricts the investment of City surplus funds to very conservative, highly liquid investment vehicles. This restriction is a result of the Orange County bankruptcy in the mid-1990s.

Pension funds have much more leeway to invest in less liquid investments such as stocks and real estate, that over time generally deliver a higher yield than highly liquid investment options (such as money market funds). This is appropriate for a pension fund because the inflow and outflow of funds is very certain, and thus monies can be committed for longer time frames. Because of these differences, the City currently earns approximately 4.70% on invested funds while the City pension funds assume an average annual rate of return of 8.00% (Police and Fire) and 8.25% (Federated).

### **Pension Obligation Bonds**

The combination of restrictions on City investment options and the higher returns available in pension funds has spurred the growth in use of POBs. Since 2002 at least 25 cities have issued POBs in amounts ranging from \$5 million to \$205 million. During the same time period, 18 counties have also issued POBs in amounts ranging from \$30 million to \$400 million.

POBs can be risky if they are relied on to fund a relatively large share of pension obligations. However, in San José, the Police and Fire plan is almost fully funded and the Federated plan is 81% funded. The City

Finance Director has proposed that the City could issue approximately \$156 million in POBs to raise the funding level of the Federated plan to approximately 90%.

The higher earnings on funds invested in the Federated plan would translate into lower contribution rates for the City. Estimates are that a POB issuance could generate annual savings ranging from \$1 million in the first year to \$3 million beginning in year seven, and then continuing throughout the 30-year life of the bonds.

### **Pre-Pay Annual Employer Pension Contributions**

This strategy was suggested by the Mayor's consultant to the BSAG, Roger Mialocq of Harvey Rose and Associates, and further developed by the City Finance Director. It is again predicated on the fact that the pension funds, on average, earn more than City funds.

Currently, the City makes employer pension contributions with the bi-weekly payroll. Under the suggested approach, the City would instead pay the pension funds its full annual obligation at the beginning of the year. The pension funds would give the City a discount on the pre-payment based on the fact that they will earn more during the coming year by having 100% of the City's contributions available for investment at the beginning of the year. The difference between the discount rate and the City's earnings rate would determine the annual savings.

The Finance Director has analyzed two approaches to accomplishing this strategy. One approach is to fund the pension contribution pre-payment from the City's cash pool, which could provide estimated annual savings of up to \$1.7 million. The second approach is to finance all or a portion of the pension contribution pre-payment with TRANs. Although TRANs are common financial tools used to smooth revenue flows for local governments, it will require more analysis to determine whether and to what extent the City can issue TRANs. Using the TRANs approach, it is estimated that pre-payment of pension contributions could save the City up to \$3.1 million per year.

Both the pension obligation bond and pension contribution pre-payment strategies are fairly straightforward from a financial perspective, but will obviously require coordination with and approval of the pension boards.

Another financing strategy that could be beneficial for the City, securitizing the tobacco settlement monies the City receives, is under study. Other California jurisdictions have used this strategy to create current income and eliminate the potential for loss of the funding due to market or legal changes. At this time the tobacco securitization strategy is not developed enough to be a part of the General Fund Structural Deficit Task Force's work.

### **3. Ensure Current Fees Fully Cover All City Costs (\$2 to \$9 million)**

A common method to increase municipal revenues is to increase the fees users pay for services. Fee levels vary widely from jurisdiction to jurisdiction, with some ensuring full or almost-full cost recovery and others charging a lower fee, with the costs of service subsidized by the General Fund.

Most people believe that user fees are fairer than taxes because they are discretionary and users have the choice whether or not to use the service. For this reason, many user fees can be market-based and can be included in the City's calculations of operating revenues for its various business lines.

San José is a demonstrated best practices leader in municipal user fees. The City annually updates a comprehensive City fee ordinance, regularly ensuring a small fee increase to keep pace with inflation and the costs of providing service. The City also has adopted excellent fee policies to predetermine the level of fee support required for various services. For example, recreation fees are set at 85% of the cost of the service and result in \$9.1 million in annual revenues. Currently, total fee charges by the City result in \$70 million in annual revenues to the City's General Fund.

Because of these practices, there is not a substantial opportunity for the City to increase revenues through fee increases. However, opportunity does exist for user fee increases for some business lines, specifically planning, police, fire, and engineering/inspections fees.

A comparison of peer city per capita averages using the 2005 State Controller's Report shows the following comparison between San José and peer city averages in Table 13 below.

**TABLE 13: PER CAPITA FEES AND SERVICE CHARGES**

<b>Fee Category</b>	<b>San José</b>	<b>Average for Large Peer Cities</b>
Zoning, Subdivision, and Plan Checking Fees	\$7.12	\$15.54
Special Police Department Services	\$2.1	\$8.96
Special Fire Department Services and First Aid and Ambulance Charges	\$5.09	\$10.19
Parking Facilities	\$10.16	\$18.97

Lack of demand for such services may be one reason that San José lags behind other jurisdictions. San José has probably also closed this gap from its constant updating of fees since FY 2005. On the other hand, in some cases, San José does not have fees in place that other cities use. (One example is emergency advanced life support medical response



services, where the City receives some transportation reimbursement, but not all the costs associated.)

In other cases, the City is not charging all costs in some user fee categories. A good example is advance planning services. State law provides that cities may impose an advance planning surcharge to offset the costs of maintaining a legally valid General Plan. This provides a benefit to those wishing to develop property. San José has such a fee, which is used for the costs of having a consultant update the plan every 10 years or so, but it yields only about \$200,000 per year while the City spends at least \$2.7 million per year on advance planning. The costs of maintaining a legally adequate General Plan include more than just consultant costs.

Another area to investigate is parking charges. A comparison of San José with peer jurisdictions shows that Sacramento, Oakland and San Diego each have much larger parking revenues than does San José. Each has more on-street metered spaces and more off-street paid parking spaces. San José currently receives on-street parking revenues of approximately \$2 million per year that are accounted for in a special fund that is dedicated to fund the City's parking system costs. Table 14 below shows the number of spaces and rates charged in some of the peer cities.

**TABLE 14: PEER COMPARISON OF PARKING SPACES AND RATES**

	<b>San José</b>	<b>Sacramento</b>	<b>Oakland</b>
On-street spaces	2,300	5,383	6,620
Off-street spaces	5,100	8,580	17 garages
On-street rates- Central	\$1.00/hr	\$1.00/hr	\$1.25/hr
On-street rates- Other	\$0.50/hr	None	\$1.00/hr
Uses multi-space meters	None	Yes - % unknown	Yes on 4,920 spaces
Who manages garages	City	City	contracts

In the central area of Oakland and San Diego, parking meter rates are \$1.25/hour and in Sacramento they are \$1.00/hour. This compares with San José's downtown rates of \$1.00/hour.

The City should consider increasing parking meter rates by 25% and placing that revenue in the General Fund, using multi-space meters for on-street parking, and recovering the full costs of overhead for management of the parking system. A 25% increase in parking meter revenues would generate up to \$500,000 per year.

Overall, with regard to fees and charges, Management Partners recommends that the City undertake a budget optimization study along the lines of the approach taken by the City of Long Beach, to ensure that

all costs are covered in applicable user fees. Many other cities have found that certain costs, such as those for vehicles and equipment inspectors, may not be fully covered by existing fee levels. Long Beach developed approximately \$4.8 million in ongoing revenues as a result of their optimization study in this area.

For purposes of this analysis, we assume if the City could enact fee increases for these services (now below market rate) the result would be between \$2 and \$9 million in new revenues. The \$2 million figure is based on setting fees to recover 70% of advance planning (see notes on this earlier) costs from permit fees; the higher estimate assumes closing the existing gap between San José per capita and average large city revenues per capita for the fee areas cited above by 33%.

If the City of San José does as well as Long Beach on a per-capita basis with this optimization approach, it would yield over \$10 million in revenues. However, we believe this would be unlikely because San José already does a good job in this area.

#### **4. Restructure Business Tax Rates to Modernize and Reflect Current Business Profile (\$6.3 to \$15 million)**

The City's business license was adopted in 1984 and the rate has remained unchanged since that time. Annually, the City collects approximately \$12.6 million in revenues from the business tax.

According to California State Law, general law and charter cities are allowed to levy a tax on business activity. Throughout the State, the nomenclature for such taxes varies, but are most commonly referred to as business taxes, business license fees, or business permits. California cities have enacted versions of business taxes in which the specific tax for a company is based on a percentage of the company's payroll expenditures. As such, municipal "payroll taxes" are not separate or in addition to businesses taxes. They are, in fact, a specific type of business tax.

In regard to the overall business tax structure for municipalities, there is no consistent structure among the San José peer cities and the City's neighboring municipalities. Six of the ten largest cities in California (by population) have complex business tax structures with a variety of discrete business categories. The cities of San José, San Diego, Sacramento and San Francisco are the exceptions. Like San José, San Diego and Sacramento separate businesses into four or fewer categories.

The fees may be fixed fees based on a per unit basis or may be based on the number of employees, gross receipts, number of vehicles, and/or the number of rental units (for landlords). Of the nine San José peer cities, only the City of Oakland has a business tax structure that includes a payroll tax for certain types of businesses. It should be noted that, although not a San José peer city, the City of San Francisco also has a payroll tax.

The City of San José is an example of a municipality that has a business license structure with few categories. San José's business license structure is shown in Table 15 below:

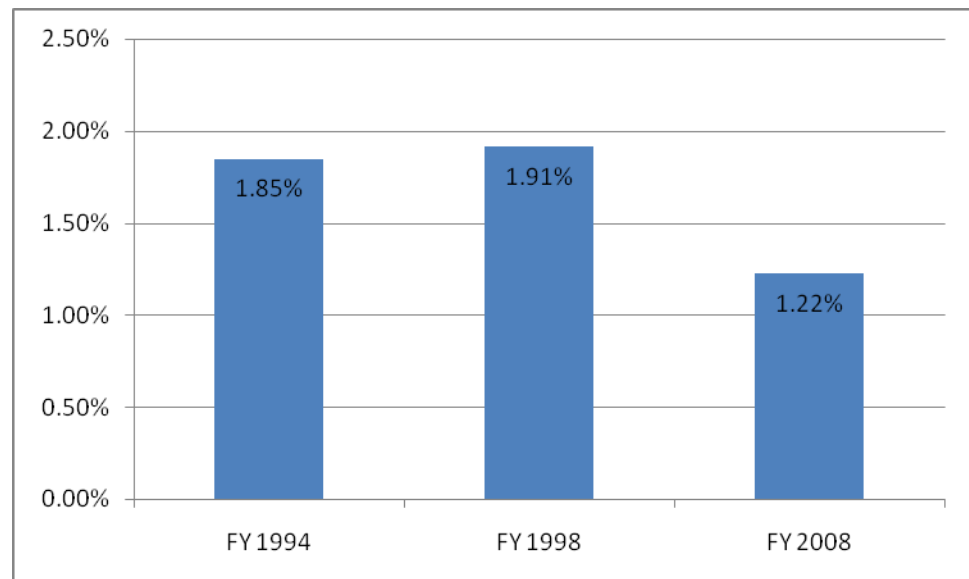
**TABLE 15: CITY OF SAN JOSÉ BUSINESS LICENSE STRUCTURE (STATUS QUO, 1984)**

Type of Business	Annual Tax	Additional Tax Increments	Maximum Tax
Residential Landlords	\$150.00 up to 30 units	\$5.00 per unit over 30	\$5,000
Commercial Landlords	\$150.00 up to 15,000 sq. ft.	\$.01 per sq. ft. over 15,000	\$5,000
Mobile home Parks	\$150.00 up to 30 lots	\$5.00 per lot over 30	\$5,000
Water Companies	\$200.00 up to 500 connections	Set per schedule up to \$20,000 for 50,001 and over connections	\$20,000
All other Businesses	\$150.00 up to 8 (owners + employees)	\$18.00 per person over 8 (owners + employees)	\$25,000

The City of San José's business license rates are at the same level today as they were in 1984. Ordinance 25182 in 1984 established the current business license structure. In November 1996, the rates were increased to reflect an annual inflation factor as a result of recommendations from the "New Realities Task Force". Retention of the new rates was contingent on voter approval. Because voters did not approve the continuation of the increased rates in November 1998, the rates were returned to their prior 1984 level.

Because the business license has remained unchanged for many years, it contributes a diminishing share to General Fund revenues. While revenues have increased from \$8.7 million in FY 1994 to \$ 12.6 million in FY 2008, the increase has not kept up with general inflation. Figure 14 below shows the trend, as well as the "spike" due to the implementation of new rates in 1998; rates which have subsequently been discontinued.

**FIGURE 14: BUSINESS LICENSE REVENUES AS A PERCENTAGE OF TOTAL GENERAL FUND REVENUES**



If the business license was brought up to date for the purchasing power change since 1984, the fees would be as shown in Table 16 below.

**TABLE 16: CITY OF SAN JOSÉ BUSINESS TAX STRUCTURE (1984 TAXES INCREASED BY INFLATION TO REPRESENT 2007 DOLLARS)**

Type of Business	Annual Tax	Additional Tax Increments	Maximum Tax
Residential Landlords	\$301.00 up to 30 units	\$10.00 per unit over 30	\$10,033
Commercial Landlords	\$301.00 up to 15,000 sq. ft.	\$.02 per sq. ft. over 15,000	\$10,033
Mobile home Parks	\$301.00 up to 30 lots	\$10.00 per lot over 30	\$10,033
All other Businesses	\$301.00 up to 8 (owners + employees)	\$36.00 per person over 8 (owners + employees)	\$50,166

In addition to setting the rate of the business license fees themselves, the rate of the administrative fee should also be considered. Most modern business license fees include an administrative fee charged by the City. The following information on administrative fees is useful:

- Fee is imposed to offset the Business License Tax account set-up costs for new businesses.
- Four of the nine big city peers have such a fee which ranges from \$10 to \$30.
- Two of the four local peers have a fee.
- One city charges an annual renewal fee in addition to the application fee.

To implement a business license increase, the City will be required to obtain majority voter approval for the changes. Increasing the license fee to fully account for inflation would approximately double current revenues (an addition of approximately \$12.6 million per year). An administrative fee could add another \$2.4 million (based on a per business administration fee of \$33 annually).

However, this would raise San José's business license to levels higher than surrounding jurisdictions (while still less than San Francisco or Oakland). Simply getting the same proportion of revenues from the business license as was the case in 1994 would yield approximately \$6.3 million in additional revenue.

Voter approval offers the City considerable leeway to design a business tax increase that would generate more revenues while not presenting a competitive disadvantage. For example, some cities exempt small or start up businesses.

As can be seen from the earlier benchmarking section, even a substantial increase to the City's current business license rate will keep it below the peer average and allow the City to remain competitive while increasing revenues.

#### **5. Modernize Utility Users Tax and/or Bring to Average (\$7.9 to \$39.6 million)**

San José could increase revenues through modernization of and/or an increase to its Utility User Tax or UUT.

The UUT is a general tax imposed on utility bills, typically as a straight percentage of the utility costs. These taxes were established originally as a payment to the City from a franchise utility. The last major overhaul in San José's UUT dates to the 1980s when the major utilities and the League of California Cities negotiated a model ordinance. San José's ordinance is based on that model ordinance. Of course, much has changed since the 1980s especially with respect to telecommunications; wireless technology and the internet revolution are the two main drivers of changes in the telecommunications "utility."

Another issue impacting the UUT is the fact that Proposition 218 has been interpreted to require voter approval of any methodology change in calculating the tax. With the service providers constantly changing the way the services are provided, tax administration methodologies also have to evolve or the tax revenues erode. Adding to the complexity are federal interpretations altering the application of the Federal Excise Tax on telephones.

As a result of these changes, over 100 cities in California that rely on a UUT including telecommunications (such as San José) have an intense interest in maintaining the integrity of their UUT. Thus, the state is

currently undergoing another round of changes to city utility taxes that is being driven mainly by litigation by the telecommunications company Verizon, which wants to reduce the scope of utility taxes as applied to its services.

Therefore, aside from the issue of closing the structural deficit, San José may need to look for an opportunity to seek voter approval of an updated ordinance for the UUT that reflects the realities of the modern telecommunications industry.

Currently San José has a UUT rate of 5%, which is lower than several peer cities. San Francisco, Sacramento and Oakland all have UUTs at 7.5% and Los Angeles has a UUT at 10%. Oakland has special provisions in place; the UUT is frozen at 5% for persons identified as being low income. In Table 17 below a comparison of UUT in major cities is provided.

**TABLE 17: COMPARISON OF UTILITY TAX RATES AMONG PEER JURISDICTIONS**

City	Utility Tax Rate
Los Angeles	10.00%
San Diego	n/a
<b>SAN JOSÉ</b>	<b>5.00%</b>
Long Beach	5.00%
Fresno	n/a
Sacramento	7.50%
Oakland	7.50%
Santa Ana	6.00%
Anaheim	n/a
Fremont	n/a
<b>AVERAGE</b>	<b>6.83%</b>
Sunnyvale	2.00%
Santa Clara	n/a
Milpitas	n/a
Mountain View	3.00%

In addition to rate variations, UUT ordinances are applied to different sets of utility services. Table 18 below compares the application of UUT ordinance for those large city peers that have a UUT.

**TABLE 18: COMPARISON OF UUT RATES IN PEER CITIES**

City	Telephone: Interstate Resid/Comm	Telephone: Int'l Resid/Comm	Telephone: IntraState Wireless Resid/Comm	Electricity Resid/ Comm	Gas Resid/ Comm	Cable Resid/ Comm	Water Resid/ Comm	2005 per capita
Oakland	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%		\$107
Long Beach	5.0%	5.0%	5.0%	5.0%	5.0%		5.0%	\$80
Los Angeles	10.0%	10.0%	10.0%	10.0%	10.0%			\$149
Santa Ana	6.0%	6.0%	6.0%	6.0%	6.0%		6.0%	\$76
Sacramento	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%		\$119
San Francisco	7.5%	7.5%	7.5%	7.5%	7.5%		7.5%	\$91
San José			5.0%	5.0%	5.0%		5.0%	\$77

San José collects UUT revenues of \$77 per capita, which is considerably lower than its peers. Los Angeles collects \$149, Sacramento collects \$119 and Oakland collects \$107.

One reason for this disparity is that the San José UUT is not as comprehensive as most other large city UUT ordinances, as it does not include interstate/international telephone services or cable television services. If the City were to modernize its UUT, it could probably broaden the application to cover emerging service approaches in telecommunications and potentially cover cable and other bundled communications services. This has been the recent trend in California.

In the November 2007 elections, 10 California cities asked their voters to modify their existing UUT. The measures endeavored to respond to changes in telecommunications technology, billing practices and federal law, by modernizing their UUT ordinances to clearly and lawfully cover new approaches to selling communications and information services.

Two of the measures modernized the UUT without any reduction. Seven measures reduced an existing city UUT on telecommunications. The City of South Pasadena was the only agency proposing to increase its UUT rate by 3% (to 8%) for a five-year period and accompanied this measure with an advisory measure requesting voter opinion regarding dedicating the tax to infrastructure (65%) and employee compensation (35%). The South Pasadena UUT increase applies to telecommunications, electric, gas, cable TV, and water utilities.

All 10 UUT measures were successful, including the rate increase in South Pasadena. The measures passed with a low 53% approval (in South Pasadena) to a high 86% approval in Emeryville. Interestingly, the

Emeryville measure did not reduce the tax levy from the current rate of 5.5%.

A study conducted for San José in 1993 indicated that broadening the UUT to include interstate and international telephone calls could increase revenues by approximately \$4.6 million per year. However, this increase is probably overstated in 2008 because so much communication is handled via wireless phones. No estimate of expanding coverage to cable is available. Some cities that have cut the UUT rate while modernizing the tax rate have experienced about a 10% increase in total revenues. For San José this would mean an increase of approximately \$7.9 million. This is probably a reasonably conservative estimate if San José kept the rate at the current 5% and simply broadened the base, especially because the City currently does not tax cable.

San José could recoup increased revenues of \$3.96 million for every 0.25% increase in its UUT rate. Increasing the tax rate to the state average for cities with a utility tax (5.5%) would represent an increase of \$7.9 million. Combining the modernization estimate and the increase to average estimate would yield approximately \$15.1 million in new revenue. Raising the tax to the average for larger cities (7.5%) would yield approximately \$39.6 million based on the existing tax structure.

Ensuring the continuation of the UUT is of extreme and overriding importance to San José. Therefore, efforts to raise the tax should be approached very cautiously, as the potential of losing this tax would be catastrophic. It is fairly clear however, that the City is going to need to confront the structural issues with the tax sooner rather than later, and there may be some limited opportunities to help reduce the structural deficit as part of this modernization effort.

#### **6. Implement Citywide Lighting and Landscape Districts or other Proposition 218 "Property Related" Fees (\$2.5 to \$11 million)**

The use of lighting and landscape districts as a funding mechanism is common among many of the peer jurisdictions. Created by the state Landscaping and Lighting District Act of 1972, landscaping and lighting districts allow local governmental agencies to form such maintenance districts for the purpose of financing the costs and expenses of landscaping and lighting public areas.

Approved uses include installation and maintenance of landscaping, statues, fountains, general lighting, traffic lights, recreational and playground courts and equipment, and public restrooms. By law, benefit assessments cannot be based on property value. Instead, each district establishes a benefit formula for each parcel in the service area. Each is assessed according to the benefit it receives from the services and improvements.



Proposition 218 (approved in 1996 to address what was perceived as a loophole in the administration of Proposition 13 in 1978) has had a major impact on reshaping assessment and even utility-related fees levied by local governments in California. However it may offer some opportunities to cities such as San José that have historically not used assessment or Proposition 218 related fees to a great extent.

Implementation of a new district requires a vote of property owners within the district following the provisions outlined in Proposition 218. Individual maintenance districts require annual engineering reports to detail the improvements to be maintained along with estimated budgets. They also require revenues and expenses to be accounted for separately for each district. Many cities contract with consultants to administer the districts.

Such fees may not be imposed unless a local government conducts a majority protest proceeding 45 days after a mailed notice to all fee payers. If no majority protest occurs (which is likely, given results in other cities), then the agency must submit the measure to a mailed ballot, majority vote of property owners. An exception applying to utility services has been quite extensively litigated, but the 218 assessment and tax provisions have been smoothly and routinely implemented in many cities.

Those peers using lighting and landscape districts generate an average of \$14.21 per capita in revenues. San José currently has 23 maintenance districts. Livermore, a city that has made substantial use of these districts, currently has 80 districts. Thousands of maintenance districts are currently in existence in California cities, approved by property owners who reside in the districts.

It is complicated to administer a new citywide district. The City has estimated that it will take almost two years from the creation of such a district until the delivery of the first tax roll of special taxes can be made to the County Tax Collector. However, creation of a citywide district or even a set of districts could address several areas of City General Fund needs. These include landscaping (including street trees), lighting, street maintenance and traffic signal maintenance.

Estimated annual net revenues for a citywide maintenance district are calculated at \$11 million; this assumes gross revenues of approximately \$13 million, less the administrative costs and less credit for the 23 districts already in place. The gross revenue estimate is based on the per capita average generated by districts in other cities (\$14.21), which would amount to a per parcel charge of approximately \$50 per year. The actual assessments are based on the cost of the services provided divided by the number of benefiting parcels.

Another approach to using the provisions of Proposition 218, and the surrounding court decisions impacting utility operations, may be for the

City to complete a study that would establish that there are some City costs directly attributable to public utility operations within the City.

Currently transfers from a utility fund to the City's General Fund can only be made based on documented reimbursement for the cost of services provided to the utility. Under this interpretation of this provision, the City is being forced to eliminate a transfer to the General Fund of over \$5 million per year from the water utility and the water pollution control plant for the in-lieu tax as well as the municipal water rate of return in budget years 2009 and 2010. However, a presentation at the California League of Cities in September 2006 by the legal firm of Colantuono and Levin suggested that transfers to support such services as the cost of police and fire protection to utility property and the wear and tear on public streets attributable to utility operations may be authorized, provided the City has an appropriate nexus study. While there would be a cost to such a nexus study, a net benefit to the General Fund for charges to the water utility for such services should net approximately \$2.5 million per year.

### **7. Levy Parcel or Sales Tax for Public Safety or Other Services (\$14 to \$38 million)**

The City of San José could explore the adoption of a parcel tax or a sales tax as a means to fund public safety or other services. Both taxes are relatively common, and are becoming more so in California. As special taxes, these measures require 2/3 voter approval. Often such taxes are used to fund some enhancement in service level or to avoid specific cuts. A complication for San José is asking voters to approve a special tax for existing services (which would help address the structural deficit) may not be as popular as a tax to fund enhanced services. In any event, considerable latitude is allowed for the City to design a tax to fund both ongoing and new services.

In the November 2007 election, eight cities/special districts proposed a parcel tax for safety services ranging from \$50 to \$300 per parcel per year. Four of these measures passed and four failed. Parcel taxes are often used as alternatives to property tax as a means to raise revenues. They are not based on the value of the property but rather are established as a flat fee per dwelling unit equivalent. Parcel tax revenues are often earmarked for a specific purpose. Parcel taxes require a vote. General taxes require a 50% voter approval while those earmarked for specific services (such as police) require a 2/3% approval.

Parcel tax proposals submitted to the voters can be structured to exempt certain classes or types of property. They can also include authority for the City Council to increase the amount annually based on the Consumer Price Index (CPI) or other index. They can be authorized indefinitely or include a provision to last a maximum number of years.

The City of San José currently has a parcel tax for libraries that raises \$7 per capita. Parcel taxes are used extensively by San José's peer cities. For example, Fremont voters approved a parcel tax to fund paramedics of up to \$15 per parcel in 1997 with an approval rate of 80% of voters.

Oakland voters have approved parcel taxes for emergency dispatch and medical services, paramedic emergency services, library services, and a violence prevention and public safety act which raise approximately \$17 million per year for 10 years. Parcel taxes for libraries and public safety in Oakland are in the \$80-\$100 per residential parcel range.

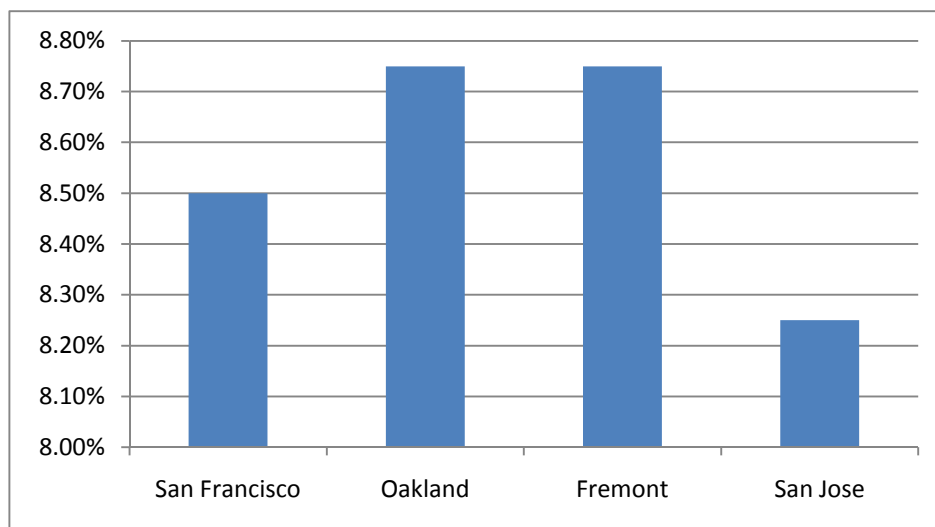
In Los Angeles, the City Council has recently proposed a \$40 parcel tax for gang prevention programs. This tax would raise roughly \$30 million annually.

A parcel tax of \$53 per parcel (the average for cities having this type of tax) in San José would generate \$14 million in new revenues annually.

Another option cities often use to fund the costs of police and fire services is to ask voters to approve a 1/8 to 1/2 cent sales tax for purchases within the City. In November 2007, two cities (Selma and Ceres) proposed 1/2 cent sales tax levies to fund safety services. Both passed with more than 75% approval. Seven cities attempted to pass a sales tax for general purposes (majority vote required). Three of the seven measures passed.

While the basic 8.25% sales tax rate in Santa Clara County is relatively high by California standards, it is actually low relative to Bay Area peers. Figure 15 below contrasts the basic sales tax rate in San José with that of other large Bay Area peer cities.

**FIGURE 15: SALES TAX RATE COMPARISON WITH BENCHMARK CITIES**



This comparison suggests that the potential may exist to propose a 1/4 cent sales tax in San José without a major anti-competitive impact.

San José currently receives one cent of the total 8.25 cent sales tax, which results in approximately \$147.9 million in General Fund revenues. Raising the City's sales tax by .25 cent would raise approximately \$38 million in annual revenues.

In November 2004, the City of Santa Rosa successfully passed a .25 cent sales tax for police, fire and youth services. It is generating an estimated \$7 million per year for this City of approximately 170,000 people. The special tax was passed by slightly more than a 70% majority. The funding was allocated to fund police and fire positions that would otherwise have been eliminated, to generate funding for new facilities and equipment and to fund gang prevention and youth programs.

A major complication with this strategy is that a sales tax increase has been considered as a revenue source to fund many other public services in Santa Clara County ranging from health care to transportation. The City of San José may confront regional opposition to placing a local measure on the ballot in the face of so many other competing interests.

#### **8. Increase Transient Occupancy Tax to Market and Shift to General Fund (\$4.5 to \$11.3 million)**

In 1982 the Council initiated a 6% transient occupancy tax, or TOT, on all hotel/motel rooms in San José. Subsequently it has been raised to 10%. These taxes are typical in California cities and are intended to offset costs of serving visitors with public services. The result is that this tax is paid primarily by visitors to the City rather than residents. The revenues are collected in the TOT fund and the increment of growth is distributed by formula to three program categories: convention facilities operations and maintenance; cultural grants; and the San José Convention and Visitors Bureau.

Currently, the City's TOT brings in approximately \$22.4 million annually (this collection level varies based on hotel occupancy rates and levels). The revenues are then split, with 4%, or \$9 million, going to the City's General Fund and the remainder, \$13.4 million, going to support the Convention and Visitor's Bureau; grants for the fine arts; and the operating subsidy for convention center facility operations. In the FY 2008 budget, a total of \$5.1 million in cultural grants is allocated to 86 different agencies.

San José's TOT revenues per capita of \$23.70 are well below the average of \$37.83 in peer cities and San José's rate of 10% is below the median peer city rate of 12%. Only one of the nine peer cities, Sacramento, allocates a lower percentage of TOT tax revenues to the General Fund.

**TABLE 19: TRANSIT OCCUPANCY TAX COMPARISON AMONG PEER JURISDICTIONS**

City	TOT	TOT Percentage to General Fund
Los Angeles	14.00%	14.00%
San Diego	10.50%	5.50%
<b>SAN JOSÉ</b>	<b>10.00%</b>	<b>4.00%</b>
Long Beach	12.00%	6.00%
Fresno	12.00%	12.00%
Sacramento	12.00%	2.00%
Oakland	11.00%	11.00%
Santa Ana	9.00%	9.00%
Anaheim	15.00%	15.00%
Fremont	8.00%	8.00%
<b>AVERAGE</b>	<b>11.35%</b>	<b>8.65%</b>
Sunnyvale	8.50%	100.00%
Santa Clara	10.00%	100.00%
Milpitas	10.00%	80.00%
Mountain View	10.00%	100.00%

According to the San José City Attorney, any TOT rate increase and/or allocation change would require majority voter approval if the proceeds are to be used for general purposes. Downtown hotels have already developed a proposal to voluntarily increase the TOT and use the increased revenues to expand the Convention Center. The Convention and Visitor's Bureau, Convention Center, and arts groups benefiting from the current distribution would likely oppose any shift of their share of the revenues to the General Fund.

The revenue estimate for the TOT in FY 2007-08 is \$22.4 million. The City could see increased revenues of \$4.5 million if the proposed 2% increase in TOT is transferred to the General Fund. The General Fund could see an additional \$6.75 million if half of the existing 6% that is allocated for special purposes is transferred back into the General Fund.

It should be noted that transferring existing revenues would need legal evaluation and that the transfer could negatively impact those service currently funded. However, it would not automatically have a negative impact. It would however subject the funding of the current services which have designated funding to the same competition for funds which occur with respect to General Fund monies. Management Partners believes that such competition improves the ability of the City Council to address the highest priority needs at any given time.

## Service Delivery Model Changes

While increasing revenues is one way to address the structural budget deficit, another is to make changes to service delivery models to improve efficiency and cost-effectiveness. This section of the report provides strategies for changing the means by which services are currently delivered in the City of San José.

### **1. Formalize and Implement a Rigorous Asset Management Program (\$3.3 to \$5 million)**

Cities own many buildings and physical facilities such as parks, garages, and corporate yards. Asset management, the process of monitoring the inventory and leasing of these investments, can and should be considered as a cost reduction strategy. The City of San José should develop a comprehensive asset management program, identify market rental rates and subsidies, and sell unneeded and under-performing properties.

An advanced asset management programs have been implemented in cities as a best practice to minimize the total cost of acquiring, operating, maintaining, and renewing infrastructure assets. The advanced programs centralize the total life-cycle costs of infrastructure. For example, the City of Charlotte, North Carolina, examined 1,100 city-owned properties and identified 162 surplus and marketable properties. Charlotte sold 125 of these properties for \$15 million in the late 1990s. The net present annual value of this funding would be approximately \$1 million per year based on the City of San José's earnings on invested funds. The City of Phoenix also has an aggressive asset management program in place.

Over the long term, an asset management program should integrate with maintenance and replacement schedules for the development of long-range capital improvement program funding needs. The identification of surplus, unneeded properties that can be sold will result in one-time revenues and a reduction in ongoing maintenance costs.

Market rate rents should be calculated and updated periodically for all City properties that are rented or leased. Properties rented or provided to community organizations, non-profits, and for economic development purposes should also identify the market rental rates as well as and the level of subsidy. The subsidies should then be supported by the appropriate program and funding source. This will identify the true costs of such programs, properly charge those programs, and provide relief to the General Fund.

An advanced asset management program will include information about each separate property including infrastructure improvements, costs, rental rates, etc. It will link to the facilities maintenance database that will

track and schedule major maintenance requirements (e.g., roof replacements) for estimating capital improvement needs.

The implementation of a formalized asset management program can result in the following savings and revenues:

- Revenues from the immediate sale of surplus properties
- Maintenance cost savings on sold properties
- Revenues from the sale of additional surplus properties after a thorough review of all properties
- Shift of rental/lease subsidies from the General Fund to various program funds
- Overall management of subsidies

Charging programs for rental subsidies will increase the costs of those programs, but will identify the true costs and will accrue savings to the General Fund.

The City of San José owns almost 1,000 parcels of land with an Assessor's parcel number, 450 buildings, and administers about 170 annual leases. Of the land parcels almost 200 are identified as being either vacant or under the "other" category, which seems to apply to open space areas and slope easements. Such parcels may be subject to outright sale or lease. For example, utility companies have historically leased land under power lines which is encumbered with a restrictive easement for the growing of nursery stock and other such uses.

Of the 450 buildings, approximately 12 are identified as being out of service, although it appears that many of the other buildings are only partially or sporadically utilized. In the community survey and the employee survey numerous and repeated references were made to the ability to sell the old City Hall on North First Street to obtain current revenues.

Finally the City has many leases (at least 35) which result in either no revenue or a token lease payment of \$1 per year or per month. These tend to be with non-profit organizations, but the value these leases confer should be more rigorously weighed against the ongoing public purpose served by the below market lease.

Estimates of specific revenues and cost savings relevant to the City of San José cannot be made until a thorough review of the City's infrastructure assets has been made. However it is clear that San José has a similar number of properties and parcels as did the City of Charlotte when it subjected these assets to a rigorous analysis. In Charlotte's case 162 surplus properties were identified and 125 were sold for approximately \$15 million in the mid-1990s. While San José may have slightly fewer properties, land values are higher. San José also has two golf courses that may be candidates for sale and which could generate considerable value. Therefore, we conclude that asset

management could generate between \$15 and \$25 million on a one-time basis for San José. Additional annual revenues will result from eliminating lease subsidies and from the present annual value of revenues generated from the one-time monies ranging from \$3 to \$5 million.

Another asset owned by San José is the water utility which serves a portion of the City. From time to time there has been discussion of selling this asset to the private publically regulated utility that serves the majority of the City. These discussions have not culminated in a sale however as the City has historically derived a benefit in terms of a payment of in-lieu taxes from the utility. In addition, having the utility has helped the City spread overhead costs.

The first benefit is now threatened by Proposition 218 interpretations and court decisions. Should the City not wish to proceed to cover other cost impacts to the City from the levy of service charges as discussed in the earlier section on Revenue Strategies, sale may be a viable option. Sale would create an opportunity to receive franchise fee revenues. This potential has not been included in the asset management revenue estimate as it would be too speculative at this point.

## **2. Combine Redevelopment and City Corporate Support Functions and Shift Economic Development Costs to the Maximum Extent Possible (\$5.4 million)**

The San José Redevelopment Agency is a public, government organization created in 1956. The Agency is the largest tax increment producing redevelopment agency in California and is active in 21 Project Areas throughout San José. Agency Project Areas represent approximately 25 % of the City's area (178 square miles).

The Agency will collect nearly \$180 million in tax increment revenue in 2007-08 based on almost \$17 billion of incremental assessed value. Following required deposits to the Low and Moderate Housing Fund and other pass-throughs, the net tax increment revenue available to the Agency is \$122.8 million. The annual debt service obligation is \$122.5 million, nearly 100% of available tax increment funds. The Agency covers much of its operating costs and various payments to the City out of its fund balance which consists of a combination of bond proceeds and tax receipts.

The Agency currently provides \$3.86 million in funding to the City to cover overhead expenses, payments related to redevelopment functions and other expenses such as economic development. This payment is a very small fraction of the revenues remitted to the Agency each year, some of which consist of property taxes which would otherwise go to the City. The Agency's operating budget includes approximately \$6 million for human resources, finance, and information services. In Santa Clara County, most cities have redevelopment as a function of their economic



development program and these internal services are provided by the city.

Other local municipalities, such as Santa Clara and Sunnyvale, provide overhead support and internal services to their redevelopment agencies. The San José Redevelopment Agency provides most of its own overhead functions, which represents duplication of services that could be provided by the City. Shifting a portion of the funding that the Agency spends on these services to the City (who would provide the services) would streamline operations, provide additional revenue and save money for the Agency. Currently, the Agency is spending \$6 million to provide these services.

These services typically have significant economies of scale associated with delivery. For example, the marginal cost of adding employees to an existing payroll system is minimal. The City and the Redevelopment Agency could both benefit from consolidation of corporate support services. The City would benefit by having a larger base over which to spread costs, while the Redevelopment Agency would benefit from lower operating costs. The support operations could be consolidated with existing City support operations and 90% of the current costs (\$5.4 million) could be shifted to the City in exchange for the same level of service. This cost estimate could be refined based on actual experience and as actual costs are tracked, but shifting 90% of currently incurred costs to the City in exchange for the same level of service would represent a benefit to both the Agency and the City.

Most cities in Santa Clara County have a more integrated organizational structure for economic development and redevelopment. In San José, both the Redevelopment Agency and the City perform economic development functions. Economic development is only part of the mission of the Agency. The City's economic development mission is citywide, including businesses located in the redevelopment area.

Centralizing all economic development functions within the City's Office of Economic Development and shifting additional revenues to the City to perform these functions would eliminate duplication and streamline economic development goals and outcomes for the Agency and the City. Currently, the Agency funds approximately 50% of the budget for the Office of Economic Development. Given the assumption that the majority of the businesses in the commercial and industrial areas are located in the redevelopment areas, shifting the economic development functions to the City and increasing the revenue from the Agency from 50% to 75% would allow the City to consolidate the economic development functions for the Agency and the City into one operation. Streamlining these operations and slightly increasing the Agency's share of the City's economic development program would save both organizations at least \$600,000 per year.

If economic development in San José is consolidated, the Agency and the City must use caution to ensure that Redevelopment Agency funds are not being used outside of the Agency's boundaries. It could be problematic if the City's economic development programs were absorbed and managed by the Agency because one could argue that the Agency is operating outside its boundaries. However, if the City were to take full responsibility for economic development programs citywide, including the redevelopment area, they would be able to document appropriate use of Redevelopment Agency dollars.

If the Redevelopment Agency provided 75% of the economic development funding for the City, the cost savings to the General Fund would be an additional \$466,000 in ongoing savings. It is estimated that the overall savings would be \$600,000 from the shift of funds and streamlining the economic development functions.

The City currently funds arts programs through its Office of Economic Development. The Redevelopment Agency bylaws created three standing committees, including the Community and Economic Development Council Committee. The mission statement for this committee is, "to manage the growth and change of the City of San José in order to encourage a strong economy, ensure a diverse range of arts, cultural and entertainment offerings, and create and preserve healthy neighborhoods."

If the City provided human resources, finance and information services to the Redevelopment Agency, it could realize as much as \$5.4 million in net revenue. The balance would remain with the Agency to offset the increased contribution to the Office of Economic Development.

### **3. Revise Competition Policy, Implement Managed Competition for Service Delivery, and Optimize Work Processes (\$8 to \$13.3 million)**

One means to improve service delivery that has been proven effective nationally in past years is managed competition. The term "managed competition" refers to the idea of having internal City staff departments or divisions compete with outside service providers (contractors) for the same work. This is a way to ensure that City staff is approaching their work in a creative, efficient and cost-effective manner. If they can compete and provide service at a lower cost, they win the ability to perform the work.

The City of San José adopted a managed competition policy in 1997 and revised it in 2004. The goals of San José's process are well thought out. They are to:

- Increase responsiveness to customers through flexible service delivery
- Reduce costs and/or avoid costs
- Increase efficiency of service delivery

- Improve quality and level of service provided
- Encourage creativity and innovation in the delivery of services
- Increase opportunities to leverage resources
- Ensure the City's mission and scope of services evolve with the changing environment.

While the existence of the policy is positive, further revisions are needed to maximize its impact and improve expenditure savings. The current policy includes several impediments to implementation, including provisions for no layoff, "third tier review of employment practices," and prevailing wage requirements. The policy has only been used a few times in San José, but there are opportunities to use it much more frequently.

Managed competition has been a proven success in cities nationwide when skillfully implemented. Cities including Phoenix, Indianapolis, and Long Beach have been cited as successfully making use of managed competition processes. Its value in fostering more efficient and effective public services has been acknowledged by government reform experts David Osborne and Peter Hutchinson who wrote in their recent book, *The Price of Government*, that "the fastest way to save money and increase value is to force public institutions to compete."

San Diego County's managed competition program has been cited as a national model for other governments. Despite an aggressive competition program, County employees won 13 of the 17 managed competition processes held. In one case, the fleet maintenance employees won the bid and reduced the annual costs for fleet service by \$1 million.

The City of Phoenix has held 11 bid processes for solid waste collection since managed competition bidding began in 1979. The result has been savings of \$24.7 million combined with cost savings from managed competition for landfill operations of \$7.7 million and solid waste transfer hauling of \$6.5 million through 2005.

Other documented savings from managed competition includes street maintenance in Indianapolis, with savings of 30% from 1992 through 1996.

Charlotte, North Carolina, has also been a leader in managed competition. In the first three years of their managed competition program, the City conducted 34 competitions. Of these, 24 contracts were awarded to the city agency and 10 to private contractors. In Charlotte, each key business area (akin to the city service areas in San José) developed a five-year plan for the services in its area that were also available in the private sector. The plan had a timetable for subjecting each service to competition, a strategy for making its business more competitive, determining the reasons why a service would be retained in-house without competing, and the reasons to contract with a

private firm without conducting a managed competition in which its own unit could compete. Even the police and fire departments identified services that could bid competitively. The following services were deemed worthy of some competitive analysis.

1. Animal control
2. Building maintenance
3. Communication and information services
4. Transportation Department construction and maintenance
5. Engineering
6. Equipment services
7. Finance
8. Grounds maintenance
9. Meter maintenance and reading
10. Police and fire communications
11. Police records
12. Sanitation
13. Special services
14. Special transportation
15. Wastewater and sewer construction and maintenance
16. Water pumping and treatment

In 2006, voters in the City of San Diego approved Proposition C which asked them to amend the city charter “to allow the city to contract services traditionally performed by civil service employees if determined to be more economical and efficient while maintaining the quality of services and protecting the public interest.”

In 2002, Accenture Consulting released a study which said that “outsourcing is finally beginning to be explored as a way to transform the culture and effectiveness of government workplaces – and not necessarily with a transfer of jobs to the private sector”. The study cited research showing that governments generally can reap average cost savings of 20-40% over the life of an outsourcing contract, which typically runs anywhere from 3 to 10 years.

According to a September 2007 report, *Streamlining San Diego*, written by the San Diego Institute For Policy Research and the Reason Foundation, “a review of over 100 studies of managed competition showed the cost savings range between five and 50% depending on the scope and type of service.” In addition to reducing the cost of service, the other primary benefits of competition are quality, timeliness, accommodating peak demand, gaining access to expertise, innovation, and managing risk more effectively. The report estimated that San Diego could save from \$80 million to \$200 million per year in operating costs from the application of managed competition to approximately \$1 billion in annual non-public safety operating costs.

However, managed competition is not a panacea and there have been some well publicized failures. For example, after Indianapolis awarded the operation of its wastewater treatment plant to a private operator, the operator violated discharge standards which led to fines against the operator and the City. Management Partners has also found that initial estimates of cost savings such as those postulated for San Diego in the Reason Foundation report can be difficult to achieve.

To avoid the potential pitfalls and maximize the benefits of managed competition, the *Streamlining San Diego* report outlines the following keys to success:

- **Trained Procurement Staff:** Staff must be properly trained in contracting best practices and, in particular, how to build service level standards into agreements and monitor provider performance.
- **Centralized Managed Competition Unit:** The city should develop an expert team of procurement and competition officials to guide other departments in developing their managed competition initiatives.
- **Performance Measures:** It is crucial that the city identify good performance measures to fairly compare competing bids and accurately evaluate provider performance after the contract is awarded.
- **Reliable Cost Comparisons:** The city must establish formal guidelines for cost comparisons to make sure that all costs are included in the unit cost of providing services so that an apples-to-apples comparison of competing bidders may be made.
- **Implementing Performance-Based Contracts:** Performance-based contracts should be used as much as possible to place the emphasis on obtaining the results the city once achieved, rather than focusing merely on inputs and trying to dictate precisely how the service should be performed. Performance standards should be included in contracts and tied to compensation through financial incentives.
- **Vigilant Monitoring and Evaluation:** Regular monitoring and performance evaluations are essential to ensure accountability and transparency, and that City's management and the service provider are on the same page.
- **Employee Communication and Relations:** Managed competition may encounter opposition from public employee unions who view it as a threat. The current San José policy provides extensive communication opportunities so that employees and their representatives are appropriately involved in the managed competition process.

Management Partners recommends that San José implement all of these keys to success. Rather than having a "no layoff" policy, the City

should instead require new contractors to consider offering positions to current City employees who lose their jobs as a result of managed competition. Further, when managed competition indicates the City could more effectively deliver service using a private contract provider, the City could also seek to synchronize such realignments with normal attrition. Since the City will see higher than average retirements over the next several years due to the aging of the “baby boom” generation, this offers a unique opportunity to phase in contracting where it makes sense without having to resort to layoffs. In any event, the City should reconsider the blanket “no lay-off” policy because it makes it too problematic to gain any economic benefits from managed competition.

Table 20 below summarizes potential savings from managed competition for various City services.

**TABLE 20: POTENTIAL SAVINGS FROM MANAGED COMPETITION**

<b>Service</b>	<b>FY 2008 Budget (in Millions)</b>	<b>Estimated savings at 15% (in Millions)</b>
Fleet maintenance	\$11*	\$1.65
Traffic maintenance	11	1.65
Street maintenance	7	1.05
Street landscape maintenance	12	1.8
Facilities management	19	2.85
Park maintenance	29**	4.35
Libraries	28*	4.2
Information technology	15	2.25
<b>Total</b>	<b>132</b>	<b>19.8</b>

\*Personal services budget only

\*\*Estimated budget based upon 40% of department budget

Conservative and reasonable estimates of managed competition savings range from 10% to 20% or from \$13.2 to \$26.4 million. Applying a 15% savings through competition to \$132 million in budgeted services would generate savings of approximately \$19.8 million annually. If non-traditional managed competition services such as libraries and information technology are removed from consideration (which would be likely), the estimated 15% savings would be \$13.3 million.

Managed competition, especially when it leads to outsourcing of traditional work performed by public sector workers, is strongly resisted. Another approach which has been successfully used in large California cities is the approach of optimizing existing service delivery approaches. Under this strategy, the one-time costs associated with a managed competition approach are used to focus attention on discrete City operations (often with the help of an outside consultant) to find efficiencies. Long Beach has a good deal of experience in this area and has been able to save approximately \$4.9 million from operational and

organizational changes and over \$27 million in overall cost reductions. Some of these cuts reflect service reductions, but with the scale of the City of San José's operations, an ongoing optimization approach could reasonably yield savings of at least \$8 million per year.

We conclude, conservatively, that a combination of managed competition initiatives and optimization analysis can save the City \$8 million to \$13.3 million annually.

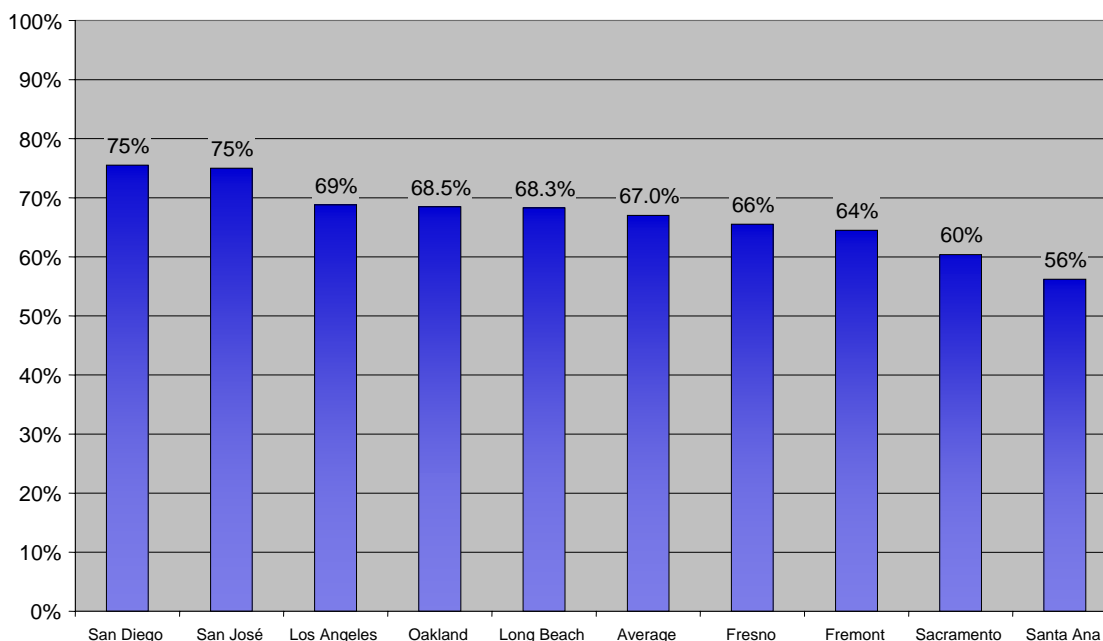
#### **4. Increase Use of Civilian Positions in Police and Fire (\$0.5 to \$1.5 million)**

This strategy would result in the deployment of more civilian personnel in public safety services with the benefits of increased productivity of sworn personnel and reduced number of sworn personnel the City would need in the absence of support from civilian positions. The major change would come from gradually implementing the use of Community Safety Officer (CSO) positions in the Police Department.

The San José Police Department has a budget of \$284 million, \$281 million of which is funded through the General Fund (representing approximately 27% of all General Fund spending). In the FY 2007-08 budget, staffing for the department totaled 1,814.46 FTEs (1,367 sworn and 447 civilian). The average sworn police officer costs the City approximately \$120,000 annually. Comparatively, the average civilian employee costs \$80,000.

Figure 16 shows the percentage of sworn police department personnel in peer jurisdictions. At 75% sworn staffing, San José has one of the highest percentages of sworn personnel to civilian personnel. One reason for this may be that San José has a relatively low number of sworn officers per 1,000 population compared with other cities.

**FIGURE 16: PERCENTAGE OF SWORN POLICE DEPARTMENT PERSONNEL**



In recent years, jurisdictions across the United States and internationally have added community safety officer positions to leverage the deployment of sworn personnel. For example, a detailed study of productivity/personnel optimization in the City of Dallas recommended a 10-fold increase in civilian police service officers, with a less than 10% increase in sworn personnel. This study was completed because it was recognized that by freeing sworn staff to work on duties only a sworn person can do (notably making arrests), civilians can make sworn staff more effective. Because civilians are also paid less, the division of labor makes financial sense.

The distinguishing characteristic of sworn officers is the ability to detain suspects and make arrests. Evaluations of whether to use sworn officers often use criteria such as:

- The position requires the law enforcement powers of a sworn officer
- The skills, training and experience of a sworn officer are needed to effectively perform the job duties
- The skills, training and experience of a sworn officer are not required to effectively perform the job, but assigning the position to a sworn officer is beneficial to citizens and/or the department and the value of these benefits outweigh the costs

Traditionally, because of their useful skill sets (such as the ability to handle a variety of people and situations), sworn personnel have engaged in a wide range of activities, many of which do not require sworn status. However, several factors including the escalating costs of



employing sworn personnel, community policing priorities, and difficulty in hiring sworn personnel have led to increasing use of civilians.

Between 1995 and 2004, California law enforcement agencies (in the aggregate) increased the ratio of civilian to sworn personnel from 0.47 to 0.53 (State Attorney Generals Annual Report on Crime and Criminal Justice Statistics). San José has a relatively low ratio of civilian support personnel to sworn staff measured against state averages and comparable cities.

By adding more civilian support personnel, the City will save money, and be able to dedicate more police officers to the duties most critical to the City (investigating crime and arresting suspects). In fact, Management Partners believes that the Police Department can increase the amount of time officers spend on sworn duties by adding civilian staff (thereby leveraging the time of existing officers) rather than by hiring more police officers. This is based on the fact that many other cities have demonstrated that certain tasks can be successfully handed off to civilians.

Diminishing returns are a factor that may limit the returns that could be gained from hiring civilian personnel. However, based on observations and other law enforcement studies, San José is well-positioned to take advantage of the steep rate of return on investment from this strategy. The preliminary analysis shows that San José may have an opportunity to grow an even more efficient police force by gradually adjusting the ratio between sworn and civilian personnel.

By hiring CSOs instead of more sworn officers (or at least adding more civilian personnel at a faster rate than currently planned) the City's current contingent of sworn officers would have an immediate increase in available time and the new CSOs would provide improved response time to lower-priority, non-critical activities. These strategies would include taking traffic collision reports, cold burglary reports and the like. CSOs are less expensive to train, can be on the street more quickly, and require less equipment; they are a "force multiplier."

Other areas where civilians may be utilized in police and fire services include training, research and development, front desk, completion of background checks and the supervision of largely civilianized functions such as records, crossing guards, building inspections and communications.

In comparison with other large cities, San José already has a relatively lean Police Department, and the same is true to a lesser extent of the Fire Department. Therefore, savings from civilianization are expected to be modest in the near-term and of limited benefit with regards to the structural budget deficit issue in the three-year timeframe. In fact, it would require adding staff to be able to redeploy sworn staff.

In 1996 an audit by the City of San José estimated that police costs could be reduced by 3% to 5% as a result of evaluating staffing methodologies to include improved shift scheduling and use of civilians instead of sworn staff. At that time, the estimated cost savings would have been \$4 to \$7 million. Today it would be worth \$8 to \$14 million.

Management Partners believes that a carefully and incrementally adopted policy of civilianizing certain tasks in police and fire could save up to \$1.5 million in three years, which would be phased with department retirements. These are modest cost savings in the near term but a focus on this approach could result in much larger savings over the next 10 to 20 years relative to continuation of the existing staffing pattern.

Management Partners also believes that the creation of part-time sworn police positions with pro-rated benefits may allow the department to better optimize shift scheduling, and could produce significant, but currently unknown, savings from a reduction of overtime. It may also be possible to use such a system in the Fire Department, resulting in a reduction in overtime expense. This suggestion arose in discussion with the San José Police Department and utilization of such a system is not known to exist in another large California city. It may be worth some targeted study.

## **5. Eliminate Binding Interest Arbitration (Future Cost Avoidance)**

The City Charter includes a provision that requires that negotiations with public safety employees are subject to line item interest arbitration. This provision means that when the parties disagree they bring the matter to an arbitrator who can rule on items individually. The provision has also been interpreted to require arbitration of situations where the employee group believes City action will change the status of a benefit – as perceived by the employee organization. Another type of arbitration, package arbitration or final offer arbitration, where the arbitrator must choose from the overall best and final option submitted by each side may produce more emphasis on compromise.

Since its availability, there have been five binding interest arbitration decisions. Management Partners reviewed the San José's binding interest arbitration decisions to determine instances in which arbitration panels awarded public safety unions benefits above the City's final offer and the status quo at that time. Such awards are listed below.

### **2007 Arbitration with Fire Union**

- 2% premium pay as a result of terrorism training
- Additional retirement survivorship benefit
- Increase in retirement formula from 2.5% to 3%

### **1997 Arbitration with Police Union**

- Increase in retirement benefits

1994 Arbitration with Fire Union

- Increase in wages

1993 Arbitration with Police Union

- Increase in wages
- Increase in orthodontic care benefits

1991 Arbitration with Fire Union

- Increase in wages
- Increase in special pay for EMT employees

Analysis of these awards shows that compared with the total number of issues decided by the arbitration panels, the number of decisions that have given public safety unions benefits above the City's final offer and above that which they already enjoyed is limited. However, the initial and compounded financial impact of such a decision is significant.

Modification to the current binding arbitration procedures was documented as a high priority with the senior executive group of stakeholders. Other stakeholder groups did not see the need for changes.

An analysis of this provision by the City in 1996 determined that salaries for public safety had increased faster than the personnel costs for other City employees since 1981 and attributed at least some of this differential to the impact of binding arbitration. Since that time this pattern has continued. Police and fire represented employees have consistently been awarded higher increases than other City employees. While some of these increases have been directly attributable to binding arbitration, others have not. However, as noted in the City's analysis of this issue in 1996 which suggested to moving to package arbitration:

*Line item arbitration is viewed [by the New Realities Task Force] as a disincentive to good-faith bargaining since all issues can be individually decided upon by the arbitrator. In package arbitration the arbitrator must choose between the final offers of the two sides. This is believed to place a greater burden on both sides to negotiate in good faith and reach a compromise because they will either win or lose all through arbitration.*

This view found powerful support in the most recent arbitration decision received by the City involving the Fire Department. The compendium of decisions on this arbitration was released in August 2007. As usual, both sides won some individual issues and lost some. The Firefighters Union won a major victory in securing additional pay for anti-terrorism training, which will cost the City approximately \$5 million. In a closing statement in the 2007 arbitration case between the City and the Fire Union, Jerilou Cossack, Chair of Arbitration Board stated that *"whereas the collective bargaining process envisions compromise and encourages innovation, the interest arbitration process does neither. The parties in this dispute did not use the bargaining process to their advantage. There was*

*precious little discussion between them about many of the proposals... there can be no meeting of the minds if there is no dialogue.*

Since City management and even the arbitrator seem to agree that the current approach is flawed and is driving a wedge between management and employees, it seems the time is right to discuss this issue with the police and fire collective bargaining groups. Given the fiscal realities facing the City perhaps now is the time when some common ground can be found so that collaborative and innovative approaches are encouraged rather than discouraged.

Since this change would be prospective, no cost savings are estimated for purposes of closing the structural deficit, but going forward a more collaborative approach to bargaining compensation issues could prove vastly superior to continuing with the current approach.

#### **6. Modify Minimum Fire Staffing Policies Where Appropriate Based on Fire Strategic Plan (Dollar impact to be determined)**

The Fire Department is currently completing an update to their Strategic Plan. This plan is expected to test alternative service delivery methods which may impact current staffing approaches.

No savings have been estimated based on these potential service delivery system changes because it would be premature to do so. It is clear that the existing service demands on the Fire Department have changed greatly, with an increasing number of medical calls. The basic service delivery approach, however, has remained relatively static.

The Fire Strategic Plan should be used as an opportunity to consider how to deploy existing staff more effectively to increase productivity and minimize continuing expenditure growth.

#### **7. Implement an Employee Suggestion and Process Streamlining Program (Up to \$1 million)**

A portion of the employee survey conducted during the current project was an open ended question that allowed survey respondents to "provide any other recommendations or considerations for solving the structural deficit." The comments received just from City employees encompassed over 147 pages and included approximately 950 comments.

In a review of the comments, many employees had valuable suggestions and opportunities for the City to save or increase revenue. The opportunities varied from very specific to general ideas. Several common themes arose within the suggestions. They included empowering lower level employees to have more decision making authority and engage employees in the process of improving efficiencies. One other unique suggestion also appeared throughout the survey responses as employees spoke about their skill sets; specifically, that the City should

utilize employee skills and experiences from previous employment into their work with the City.

The ideas were categorized into the three major strategy categories plus Service Reductions and were qualified or disqualified using the same criteria as discussed in a previous section of the current report.

The following quotes are examples of survey comments that both highlight the common themes as well as provide examples of types of comments received:

- ✓ *"Many years ago, City Management created a "Continuous Improvement" Program...but it seemed to just fizzle out or die. There are certainly ways we can work smarter not harder or longer. I strongly believe that in what I have seen in the 24 years I have worked here. Management personnel...should have meetings with their sections, employees, and look at tasks and find ways to work smarter and faster and maybe streamlining or eliminating redundant or unnecessary tasks. In that way, everything would be more efficient, take less time and you would need less people...."*
- ✓ *"Consolidate Housing Rehabilitation Inspectors into Code Enforcement. Have Code Enforcement conduct property crime investigations rather than PD."*
- ✓ *"Cutting the number of deputies/supervisors/managers in half, and establishing more decision making and authority at the supervisor and manager positions, would dramatically streamline the system; not to mention the money used on staffing those positions could go to part-time staff that are needed in the City's community centers, etc."*
- ✓ *"Reduce the number of sergeant positions in the Police Department until there is a 10 to 1 ratio to patrol officers....Reduce the number of battalion chiefs by 15%....Consolidate servers... City Manager work with Mayor/City Council to reduce the City's administrative work plan or at least if something is added to the work plans something is deleted... Improve City employee morale. This will result in better productivity and team work."*
- ✓ *"Provide coaching for supervisors to get rid of poor performing City employees. There are too many people that are underperforming; this burns out the high performers and further feeds stereotypes about government employees. "*
- ✓ *"Start a resource pool based on current employee resumes and resources. The city hires educated people and often overlooks*

*their educational base; this leads fiscal managers to view employees as expendable liabilities instead of assets."*

- ✓ *"Eliminate the bureaucracy inherent in a Government environment by examining work processes and updating those processes to create a more efficient and effective outcome... Make better use of technology!"*

When reflecting on the number and quality of the comments and ideas evoked from the employee survey, the idea of an Employee Empowerment and Suggestion Program evolved. The program would allow employees to make similar suggestions and raise ideas on an ongoing process. The City would regularly examine ideas and vet them through a similar qualify/disqualify process as has been outlined in the report. Any idea or suggestion, when put into practice, that reduces expenditures or raise revenue for the City would be publically recognized and the employee would receive a financial reward. Similar municipal programs either award a flat fee or percentage of cost savings to employees.

As is the case with many public and private employers, the City of San José has been forced to adjust and react to changing global economic forces. Because of the reduction in the City's General Fund revenues resulting from the most recent economic downturn, the City has made substantial reductions in expenditures. One of the most significant changes was to reduce the total number of employees by approximately 450 FTEs.

The need for greater speed, agility and resilience for improving the City business processes and the quality of service has never been greater than today. If the City is going to be able to continue to meet the demand for increased services and to, at the same time, eliminate the structural deficit, the organization will need to make significant changes in employee engagement, involvement and continuous improvement. Because of the slow growth of projected future revenues the organization will need to find creative ways of accomplishing more with the same or fewer employees.

The changing workplace in, "downsized, reorganized and streamlined" organizations often results in periods of chaos, fear, uncertainty and political battles, all contributing to lower levels of the employee engagement and commitment. Recent research by the Gallup organization reported evidence of a downward spiral in employee commitment. Gallup discovered that only 26% of employees consider themselves "actively engaged" in work. A lack of engagement by most employees represents a significant untapped resource for most organizations. Given the environment, the City of San José will need to make consistent and substantial changes in the organizational culture of employee engagement and commitment to continuous improvement. It is particularly important in service organizations like the City which

depends on the creativity, innovation, and competence of individual employees and teams to provide City services to all residents.

At the same time the City is "reducing the rate of increase in salaries and benefits" as recommended in this report, it must develop and maintain an organizational environment which attracts and keeps talented employees. The valued employees are committed to continuous improvement and are each fully engaged in the success of their work unit, department and City organization.

To engage the substantial talent and creativity of its 6,992 employees, the City cannot settle for an "employee suggestion program." Rather, the City should implement a comprehensive program to involve all employees in identifying and implementing ideas to reduce costs, streamline processes, and improve service quality and customer satisfaction. A change in organizational values and culture must be driven by leadership from the top of the organization and should be linked to the City's strategic plan and department's business plans.

Opportunities for implementation of best practices and process improvements by employee teams must be based upon knowledge of citizen and customer expectations and priorities. Improvement efforts should take advantage of, and expand the current organizational use of data and analysis to support performance management. Each of the City Service Areas should identify the critical processes that are involved in the delivery of their key services. The processes should then be mapped and restructured by the employees who are doing the work and delivering the service. The goal is to restructure the process to reduce cycle times, increased quality, reduce costs, and consistently meet customer and residents expectations.

The City of San José has previously engaged in similar improvement efforts. Several departments continue to operate similar programs and have even structured it into their yearly budget processes. It is important that the City develop a program which is consistent with its own organizational culture and customer needs. The most important element is to involve employees who are actually doing the work in a structured process to identify, prioritize, and implement process improvements and other changes that will reduce the cost of providing services and increase levels of customer satisfaction. Whatever tools and methodologies are used to improve performance should enable employees to satisfy core values of empowerment, achievement, creativity and recognition.

Although it is clear that the rate of growth of personal services cannot exceed the rate of growth of overall City revenues, if the City implements a successful employee involvement and continuous improvement program that results in tangible increases in productivity and quality improvement, the return on investment to the City and the employees will be significant. For example, if ideas and improvements implemented by

employee teams can increase the productivity of the organization by only 5% per year, it represents a cost avoidance of approximately \$90 million over the next three years. Although it does not represent actual reduction in expenditures, it does allow the organization to take on the natural growth in service demand without adding employees and their expenses.

The outcome of an employee suggestion program would be twofold: to collect and utilize the productive and attainable ideas derived from employees, and to continually engage employees in a process of making the City better. Employee empowerment can benefit the organization by creating buy-in for new ideas from most employees, allowing them to feel a better part of the leadership of the organization and generally creating a spirit of a shared objective and commitment to continuous improvement.

Metrics on employee involvement and suggestion programs are kept by the Employee Innovation Association. Each year the association awards top performing organizations and publishes a statistical compendium of results. While most participants are private sector organizations the public sector is also represented. In 1998 the State of Ohio won the award for employee suggestion programs involving more than 10,000 employees with its Innovation Ohio program. While Ohio has a General Fund budget approximately 25 times the size of San José's it reports a net savings of approximately \$15 million per year.

Miami-Dade County also has a well known employee suggestion program. The County indicates this program generates from \$1 million to over \$2 million annually in savings. This is on a basic operating budget of \$4.6 billion per year.

Based on this preliminary data we conclude that the City of San José could net from \$250,000 to as much as \$1 million per year in savings from a modern employee innovation encouragement program. However to be conservative we would count on no net savings at the low end of our estimating range. While the dollar savings are not huge, cost avoidance would be another plus as would employee development and morale building.

## **Expenditure Controls and Shifts**

A third means by which to eliminate the General Fund structural deficit is to restrain spending and outlays. In this section, we share strategies identified to either reduce current spending and shifts from the General Fund, as well as identify opportunities to shift funds into the General Fund.



### **1. Shift Healthy Neighborhood Venture Fund Funding to General Fund (\$5 to \$9 million)**

The Healthy Neighborhood Venture Fund (HNVF) was created to fund health related programs in 2000 from proceeds from the tobacco settlement. San José estimates \$250 million will be received over 25 years from the national settlement with tobacco companies. The settlement may in fact be perpetual, based on subsequent legal decisions.

The ordinance establishing the special fund approved an allocation fund which provides allocations to the following program areas: education and health; senior services/health; and tobacco free community/health. The goal of the education/health activities funding area is to "improve the academic success of San José students through programs that address unmet health care needs and provide for healthy developmental age-appropriate activities."

The goal of the senior services/health category is "to improve the quality of life for seniors by increasing subsidized programs and services, providing for basic health and nutritional needs, and promoting independent living through social and recreational activities."

The goal of the tobacco free community/health category is "to decrease the use of tobacco products and related health problems associated with tobacco use for San José residents, contributing to improve overall health for the City's population."

Currently, the money is allocated to the City and many other organizations and agencies that provide these services. The City's FY 2007-08 operating budget includes \$6.4 million allocated to a broad spectrum of 76 community-based agencies, many of which serve minority and low-income clients. These funds could potentially be available for allocation to higher priority City services and programs.

A shift of these funds from the current recipients would likely result in objections from those providers. In doing so, the City could see new revenues from \$5 to \$9 million per year by shifting HNVF funding back to the General Fund.

Another approach to this issue, which would be something of a middle ground, would be to revert only a portion of the HNVF funds to the General Fund and retain some designated monies for non-profits. This would best be approached with a rigorous competitive and outcome based contract approach dealing only with non-profits that are supplementing current City services.

## **2. Reduce Worker's Compensation, Disability and Overtime Costs (\$3 to \$4.2 million)**

One method to control expenditures is to reduce costs for worker's compensation, disability, and overtime. The sections below offer three options for doing so.

### **a. Revise Worker's Compensation Program**

In March 2007, the City received a report from Arm Tech that outlined recommendations for improvements to the City's workers compensation program. The consultant's recommendations are consistent with similar recommendations made by a separate consultant report for the City of Long Beach as means to improve cost effectiveness of the workers' compensation program.

Table 21 below shows a comparison of the recommendations in the Long Beach workers compensation review and how San José's program currently operates.

**TABLE 21: COMPARISON OF LONG BEACH WORKER'S COMPENSATION RECOMMENDED IMPROVEMENTS AND CURRENT SAN JOSÉ OPERATIONS**

<b>Long Beach Recommendation</b>	<b>San José Efforts</b>
1. Consolidate all WC-related management functions (claims administration, return-to-work, safety and loss control, and occupational health) under one City office.	All WC-related functions are under Risk Management in HR. The safety and loss control function has been strengthened by the addition of one safety officer and the joint reporting of all departmental safety officers.
2. Engage an integrated managed care services firm to provide nurse case management, utilization review, and preferred provider network services.	After a thorough RFP process the City selected Fair Isaac as the cost containment company, providing medical bill review, nurse case management, utilization review, and preferred provider network services.
3. Develop a WC Executive Steering Committee representing the City Attorney, City Manager, and City Auditor's Offices to oversee the re-engineering process	The City has established a Risk Management Planning Board, consisting of core members from the City Manager's Office, City Attorney's Office, Budget Office, Finance and Human Resources Departments. Other major line departments are also represented (Airport, ESD, DOT, Police, Fire, PRNS, and GSA).
4. Develop, communicate, and provide training of written Citywide WC policies and procedures incorporating best practices.	The WC manual is being updated constantly to reflect changes in the legislative arena and best practices in industry. Specific performance standards regarding claim administration have been developed and communicated to all WC Adjusters. Performance evaluations are based on how well they meet the performance standards.

Long Beach Recommendation	San José Efforts
5. Remove low-value functions from occupational health workflow, allowing more time for performance of core services.	HR is planning to submit a budget proposal to add one medical assistant position to lessen the routine medical workload of the City physician and 1.5 nurse practitioners to allow them to devote more time to wellness and disease management.
6. Select, purchase and implement a new fully functional electronic claims administration system.	The City is upgrading the WC electronic claim system to Windows-based Renaissance. The upgraded system is expected to go live in December 2007. This system will allow adjusters to manage claims more efficiently by automating routine reporting and diary functions.
7. Initiate an accelerated claims closure project.	WC has engaged in closing projects at least once a year (if standards are not met or exceeded) to ensure that the inventory of claims are current and assist with a more equitable distribution of workload.
8. Initiate best practice standards of telephonic three-point contact on all new claims.	The addition of five new adjusters added in 2007-2008 will allow staff enough time to accomplish this best practice.
9. Shift the focus of the WC claim manager from claims handling to more strategic management of the WC Claims Department	With the addition of five WC adjusters, the two existing WC supervisors will not have a caseload to allow them time to focus on training, coaching, and achieving performance standards. This leaves the WC manager with more time to focus on strategic management of WC.

Long Beach Recommendation	San José Efforts
10. "Change Management": The communication of policies and procedures changes and training requirements must be effectively communicated throughout the organization to effectively implement change.	The City Manager has informed the City Council of the consolidation of risk management functions. Presentations were conducted for Senior Staff and Council Committees. Staff were engaged during the risk management assessment and implementation of recommendations.
11. The City will be best served in the long-term (3+ years) through the in-house retention of WC claims administration.	City self-administers WC claims with an in-house staff.

As a strategy to reduce the structural deficit, we recommend that the City make it a high priority to implement recommendations from the March 2007 Arm Tech study. City staff estimates that cost savings from the recommendations will be \$700,000 in the first year and will increase to \$3.5 million annually by the end of five years. However, the savings will only materialize if the City pursues an aggressive implementation schedule. We assume a conservative estimate that the approximately \$1 million in savings can be realized annually. This represents about 6.3% of current costs.

**b. Revise the City's Disability Leave Program**

As identified in the *2007 San José Police and Fire Departments: Impact of Working Conditions on Disability Retirement* report, the City can realize retirement pension cost savings by offsetting the retirement pension of sworn personnel with permanent disability workers' compensation benefits. At this time, sworn personnel receive their regular pension and workers' compensation temporary and/or permanent disability payments (if they are disabled) upon retirement.

Disabled sworn retirees receive workers' compensation disability payments in addition to their regular pension. Best practice research has revealed that employers maintain effective disability programs and benefits that reimburse employees up to, but not more than, their normal compensation or normal pension benefits when disabled. Other PERS agencies reduce the regular pension if the retiree is receiving workers compensation benefits, as is the practice in the City of San José for civilian employees.

As noted in the *City's Police and Fire Disability Retirement Study*, "...since 2004, the City has paid a total of \$5.25 million in temporary and permanent disability to Police and Fire retirees". Sixty-two percent of police and fire retirees receive both their regular pension and workers compensation disability payments.

The City could realize savings by reducing police and fire retirement pension benefits for permanently disabled retirees to adjust for workers compensation benefits. Such a change would need to be negotiated with bargaining units.

The City estimates that this change to treat police and fire employees like other city employees would save \$1.7 million annually.

**c. Revise Overtime Eligibility Policies for Battalion Chiefs to Be Consistent with Fair Labor Standards Act (FLSA)**

The City's overtime policy for battalion chiefs in the Fire Department is currently more generous than that required by the federal Fair Labor Standards Act (FLSA), resulting in sizeable overtime payouts. The current labor agreement covering battalion chiefs in the Fire Department requires time and a half payments for hours worked in addition to the normal shift. In FY 2006-07, the City paid \$827,000 in overtime payments to battalion chiefs. There were four battalion chiefs who were paid more than \$200,000 a year in salary plus overtime.

The purpose of a battalion chief is to be in charge of a shift or a function for the department. Battalion chiefs must meet the following requirements to be considered exempt employees under the Fair Labor Standards Act:

- Pass a salary level test more than \$23,600
- Pay a salary of a guaranteed minimum amount
- Perform executive duties such as supervising two or more employees
- Management is their primary function
- Have input on job status such as hiring, firing, promotion, and assignments

Implementation of this strategy will require negotiating changes with the bargaining unit and overtime treatment unique to the 56-hour shift requirements for battalion chiefs (some are on 40-hour administrative shifts).

Although overtime for battalion chiefs probably cannot be completely eliminated, it can be substantially reduced. The estimated cost savings is \$600,000 annually.

This change would also eliminate a current financial disincentive which exists to promote to a management position in the Fire Department. Many chiefs and deputy chiefs work more than 40 hours per week, but are not compensated beyond basic salary. Some battalion chiefs make more by earning overtime, yet may not work any more hours.

### **3. Shift Construction and Conveyance Tax Funding from Capital Projects to Operating and Maintenance Costs (\$6 to \$12 million)**

The Construction & Conveyance Tax is a flat rate assessed to residential, commercial and industrial development. The conveyance tax is a fee imposed at a rate of \$3.30 for each \$1,000 of the value of property conveyed. The vast majority of these revenues (about 98%) are derived from the conveyance portion of the tax. Construction and Conveyance Tax (C&C Tax) funds are general taxes that have been dedicated mainly to the park and community facilities, communications, fire, library, and service yards capital programs.

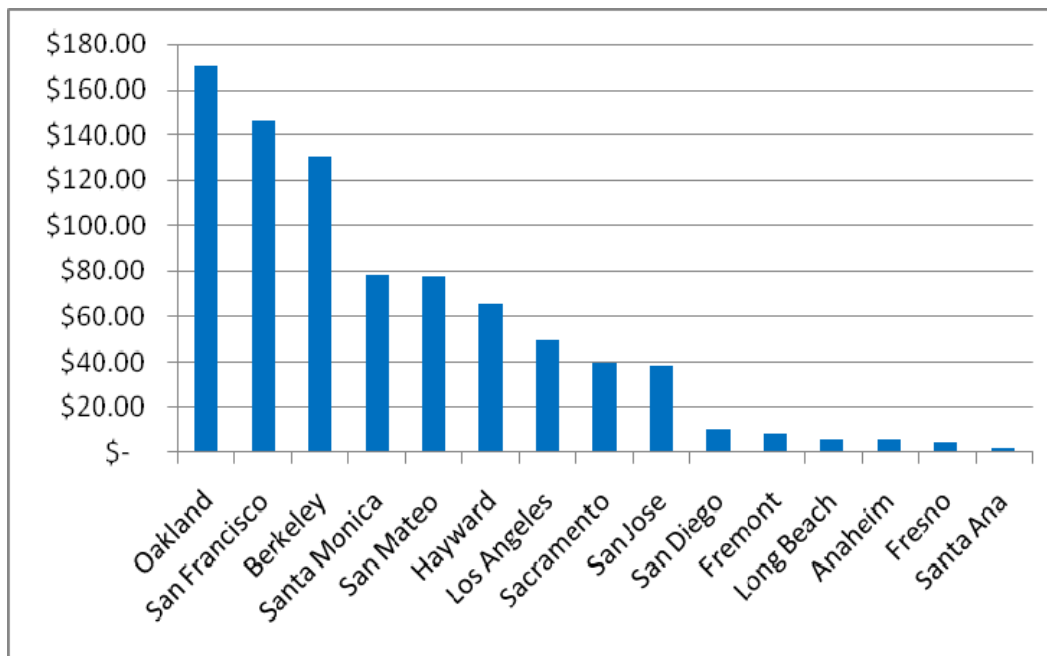
In FY 2008-09 the C&C Tax is expected to fund approximately \$57.5 million in capital improvement projects. Similar amounts are set for expenditure in 2009-10 and 2010-11 by adopted CIP. These expenditures are subdivided into 17 different sub-funds including: 12 parks' funds (one for each council district, a citywide fund for regional parks, and a central fund for parks administrative and central functions); library; fire; service yards; communications; and parks yard construction.

Benchmarking information developed from other large cities in California and in the Bay Area, documented that the C&C Taxes, also known as real estate transfer taxes, are quite common. However there are markedly different ranges for the tax rates charged with substantial regional variation.

Of the 20 cities collecting the most revenues from this source (2005 data) 14 were located in the Bay Area. Piedmont, with a population of just over 11,000 people, collects almost four times the revenue of Santa Ana (population of approximately 400,000) and just about the same amount as Long Beach (population of almost 500,000).

Figure 17 below shows the reported C&C tax collected on a per capita basis for the large city peers of San José and also for the other top 10 cities for this revenue source in the State of California. It is a list heavily weighted towards the Bay Area.

**FIGURE 17: CONSTRUCTION & CONVEYANCE TAX COLLECTIONS PER CAPITA  
AMONG PEER JURISDICTIONS**



The tax is used for significant revenue generation only in charter cities, as the tax has been restricted by state law for general law cities. The tax rate is generally levied as a fixed dollar amount for each dollar of property valuation (although San Francisco has a sliding scale). San José's rate per thousand dollars of value is \$3.30. This is low for the Bay Area, but it is much higher than the amount allowed under state law for general law cities (\$0.55 per thousand). Two cities in the Bay Area are at \$15.00 per thousand (Oakland and Berkeley). Los Angeles levies a rate of \$4.50 per thousand. San José and Mountain View are the only cities in Santa Clara County that levy a tax rate higher than the state rate of \$0.55 and both are at \$3.30 per thousand.

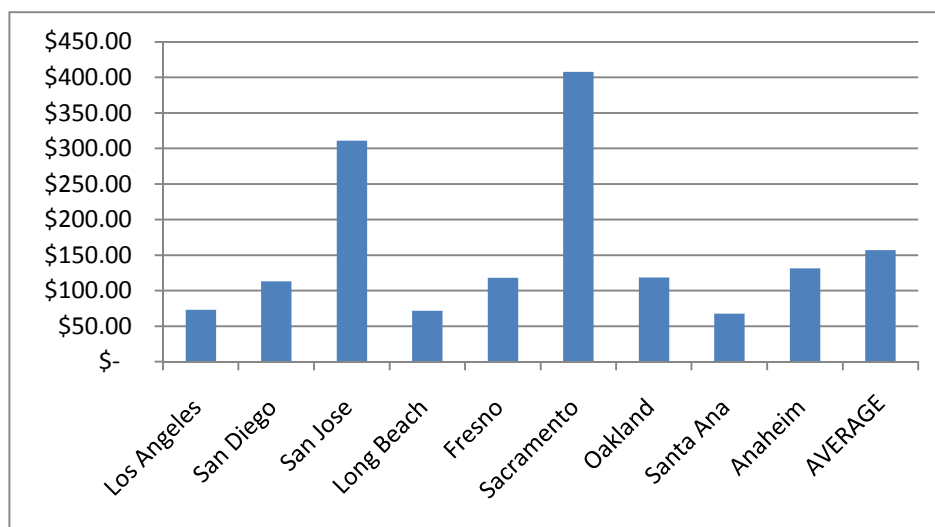
Benchmarking information gathered from other large cities in the state documented that San José is unique in using most conveyance tax revenues for capital purposes. Every other large city used the monies generated from this revenue source to fund operations.

The restrictions on the C&C tax monies in San José stem from the fact that this is considered to be a special tax. Therefore the City Attorney has determined that a vote is required before the City Council could use more of the C&C tax monies in the General Fund. In other cities the tax is considered to be a general tax and its use is shifted as priorities dictate.

Benchmarking also showed that San José has had a relatively robust program for building new facilities in the last several years. Data from the California State Controller's Report was analyzed for the fiscal year

ending in 2005. After excluding funding for enterprise activities such as public utilities, ports, and airports it was found that San José was able to spend quite a bit more than average for the largest cities in California. This data is displayed in Figure 18 below. San Francisco was excluded from this analysis as it is both a city and a county.

**FIGURE 18: CAPITAL SPENDING PER CAPITA AMONG PEER JURISDICTIONS IN FY 2005**



It should be noted that in FY 2005 Sacramento reported a large capital expenditure (approximately \$30 million) under management and support. If San José's spending on capital was in line with the average observed for the other large cities in the state on a per capita basis, it would result in an expenditure reduction of approximately \$143 million annually.

While capital spending varies widely among cities based on such variables as the status of infrastructure repair plans and the level of new development activities, San José has intentionally focused on the completion of new capital facilities over the last decade. Indeed, the 2000 to 2010 period has been called the "Decade of Investment" and San José has already completed some 800 capital projects, including new libraries, community centers, parks and fire stations. It should be noted that a large portion of these capital projects were supported by general obligation bonds approved in 2000 and 2002. All these facilities require General Fund dollars for operations and maintenance.

San José has other sources of capital funding including the Construction Excise Tax Fund that can be used for general purpose capital. In addition, as noted, the City has successfully used general obligation bond revenues for capital construction activities. Additional capital funding from the Redevelopment Agency is also an option for capital construction in some areas of the City. It is common for cities to utilize debt, grants, redevelopment contributions, and impact fees for virtually all capital construction activities preserving operating tax monies for the



support of current services. Given that the City faces a significant structural deficit it cannot afford to build new facilities that will add to the operating and maintenance costs. Therefore the strategy to shift C&C tax funding to the General Fund will provide additional monies to the General Fund to reduce the structural budget deficit and will slow the growth of General Fund expenditures by slowing the development of new facilities that the City will have to operate.

Therefore, as an important part of the structural deficit reduction plan, the C&C tax revenues should be used to the maximum extent possible to address needs that the General Fund would otherwise have to meet in the next three years. In addition these funds could be used for capital activities which will directly result in more than a one-for-one reduction in operations costs within three years. Because of the restrictions associated with C&C funding opportunities for uses which would otherwise be shouldered by the General Fund, this would need to be accurately characterized as capital. However, the City faces a host of major rehabilitation expenditures that could be funded with C&C tax revenues rather than having them used for new facilities (which will demand additional General Fund monies for operations).

Based on our analysis of the revenue source, Management Partners believes a redirection will result in between \$6 million and \$12 million in net reduction to the General Fund structural deficit. The amount may actually be somewhat larger during the period between 2009 through 2011 due to the current programming level of the C&C tax monies. (The City has budgeted utilization of both current and reserve revenues during this period.)

Implementation of this strategy will require a major revision to the City's CIP and will result in the need to reprioritize planned capital expenditures. An overall reduction in CIP activity of at least 5% in dollar spending would be expected. This may provide an opportunity to reduce management and administrative costs by at least this amount, since projects funded by the C&C tax tend to be smaller and more labor intensive than larger infrastructure projects. Due to the legal issues involved, this matter should be referred to the City Attorney for an analysis of the legal questions as well as a comparison of fund reallocation policies in other charter city settings.

If actual reductions to General Fund expenditures associated with a revised utilization of C&C tax funding cannot be found, the City may need to seek voter authorization to change the parameters for use of the money. If this is necessary, consideration should be given to increasing the C&C tax from \$3.30 to a higher amount, since the basic real estate transfer tax is relatively low in San José. City staff has estimated that an increase to \$5.78 per thousand would result in an increase of approximately \$18.8 million in C&C tax funding.

However, Management Partners believes that the main issue facing the City with regard to the C&C tax funding is that its utilization should be realigned so that it is used to reduce the General Fund structural deficit to the maximum extent practicable, and that it not be used to build more facilities that increase City costs until the structural deficit is cured.

#### **4. Reduce the Rate of Increase in Employee Salary and Benefit Costs (\$6.6 to \$10 million)**

Total personal services for the FY 2007-08 General Fund are budgeted at \$600 million, or approximately two-thirds of total General Fund expenditures. Therefore, any effective strategies to eliminate the structural deficit must include reducing the rate of increase in personal services.

During the five-year period from 2001 through 2005 the total personal services average annual increase for the City was 6.5%. During the period from 2001-2005, the average annual increase in the Gross Domestic Product (GDP) for the San José metropolitan area was 1.13% and the average annual increase to the Consumer Price Index (CPI) for the same five-year period was 2.9% for the San Francisco Bay Area. On the other hand, salaries and benefits for City employees have been and are continuing to increase much faster than the underlying economy and inflation growth in the San José metro area.

The U.S. Department of Labor conducts a National Compensation Survey of compensation cost trends. The quarterly survey produces indices measuring the change in labor costs and provides data that measures level of average costs per hour worked. The survey uses a definition of total compensation that includes wages, salaries, and the total costs of employer paid benefits. The annual increase from 2004 to 2007 is as follows: City of San José, 5.51%; state and local, 4.2%; private industry, 3.38%. While the higher cost of living in San Jose may be a contributing factor, personnel costs appear to be increasing at a faster rate relative to national averages for both the private and public sectors.

Because approximately half of the City's General Fund revenue increase or decrease is consistent with regional economic activity (GDP), the City's ability to fund personnel costs is directly linked to the local economy. While the City must be able to maintain the ability to attract and retain productive and committed employees, personnel expenditures cannot continue to grow significantly faster than the underlying economy or the structural deficit will remain.

If the growth of personal services costs from 2001 through 2005 were limited to the growth in San José GDP during the same time period, the City could have saved approximately \$36 million per year which, when compounded over the four-year period, represents a savings of more than \$150 million.

If San José had limited the rate of increase in personal services to the same rate of increase as the private sector from 2004 to 2007, the savings to the General Fund would have been about \$12.8 million a year or \$38 million for the three-year period. In the sections that follow we highlight areas where the City may feasibly control or slow the increase in personnel costs. These strategies fall into four major headings:

- a. Increase Time to Reach Maximum Compensation
- b. Reduce Entry Level Compensation for Positions for which the City Receives Many Qualified Applicants
- c. Implement Health Care Plan Modifications
- d. Implement Sick Leave Payment Modifications Upon Retirement

**a. Increase Time to Reach Maximum Compensation  
(\$1.9 million)**

**Restructure Salary Step Increases**

Personal services expenses in the fiscal year 2007-08 Adopted General Fund budget represent approximately two-thirds of total General Fund expenditures. As reported in the February 2007 City Manager Budget Message, over the last five years personal services growth has averaged 7.5% annually. The increases are made up of increases in the cost of existing and enhanced retirement, health insurance and other employee benefits; negotiated or market increases to the range; and step increases for those employees eligible for annual step increases. In order to reduce the rate of increase for General Fund expenditures it will be necessary to reduce the rate in each of the elements of personal services.

Traditional civil service salary schedules, such as in place in San José with an average of five steps in the range, were developed before the onset of widespread collective bargaining and were intended to provide an opportunity to reward employees annually for their performance and for the growth of experience and productivity as an employee learns and becomes more effective on the job. The increases are sometimes known as merit increases, although they are virtually automatic.

It only takes three and one-half years for the average employee to get to the top step of their job classification. During this time the employee is typically awarded a step increase, plus cost of living adjustments negotiated by their bargaining group. Because of this situation new employees have sometimes received raises of between 8 and 9 percent annually.

The vast majority of employees at the City are at the top of their salary range. Thus the only increase a veteran employee can count on will generally be an annual cost of living adjustment, no matter how strong their performance.

Research has shown that employees react favorably to receiving a raise and the amount is actually less important than the fact that they are being recognized for doing a good job. This leads to the idea of stretching out the current step raise system so that employees are eligible for a significant but smaller step raise for a longer period of time.

A 10 step range would reduce the City's costs and could spread the opportunity for performance increases over 9 years rather than three and one-half. The salary schedule for management employees in San José has previously been modified to change the steps in the range from 5% to 2.5%. The change in the salary schedule would need to be negotiated with each of the City's bargaining units and would be considered by both sides as part of the total compensation package during negotiations.

Table 22 below shows the budgeted monies for step increases over the last several years.

**TABLE 22: BUDGETED INCREASES**

**General Fund only**

<b>Fiscal Year</b>	<b>Dollar Value of Budgeted Step Increases</b>
2004-2005	5,823,809
2005-2006	4,932,518
2006-2007	5,665,708
2007-2008	7,752,299

**All Funds**

<b>Fiscal Year</b>	<b>Dollar Value of Budgeted Step Increases</b>
2004-2005	8,438,824
2005-2006	7,149,576
2006-2007	8,937,365
2007-2008	11,781,640

A reduction of annual step increases by 50% (from 5% to 2.5%) will result in annual savings to the General Fund of approximately \$3.9 million. If such a reduction is applied across all funds, the total savings will be approximately \$5.9 million annually.

**b. Reduce Entry Level Compensation for Positions for Which the City Receives Many Qualified Applicants (\$0.7 to \$1.7 million)**

Salaries and benefits for the City's General Fund are budgeted at \$600 million annually. The success of City services and the perception of the quality of those services by the residents of San José depends on the City's ability to attract and retain the best

and most productive employees possible. The compensation policy of the City like any organization should be to offer total compensation at the level that allows the organization to attract and keep quality employees. If the City underpays, they will not be able to attract and keep employees. Conversely, if they overpay, they are spending resources on salaries and benefits that could be invested elsewhere.

The most common market comparison used by San José in other cities to evaluate their position in the market is a salary survey of the total compensation for other comparable cities in public employers. This provides a benchmark of the San José total compensation compared to the public sector market. Quite often this is portrayed as a percentile. For example, if the employer establishes total compensation at the 70th percentile of comparable employers for each position, that employer should be able to compete for the best employees. Other important measures of market positioning include the turnover rate for specific positions and the number of qualified applicants the City receives when they advertise vacancies.

If a position experiences high turnover (greater than 10%) and very few qualified applicants for vacant positions, the City should and does consider increasing the salary range for the position. Conversely if turnover is low and there are large numbers of qualified applicants for each vacancy, the City should consider lowering the salary range. This however is not common practice in the public sector.

Management Partners has reviewed recruitment and selection data from recent recruitments for positions that received a substantial number of applications. Table 22 below summarizes this data.

**TABLE 22: RECRUITMENT AND SELECTION DATA**

<b>Recruitment</b>	<b>Date</b>	<b>Number of Applications</b>	<b>Number Invited to Test</b>	<b>Number Passed</b>
Firefighter Recruit	2006	3079	2883	939
Office Specialist II	2005	219	181	78
Office Specialist II	2007	783	452	121
Sr. Office Specialist	2007	435	291	90
Maintenance Assistant	2006	176	104	75
Maintenance Assistant	2007	525	115*	88
Custodian	2005	347	317	95
Custodian	2007	340	207	134
Engineering Technician	2005	250	177	81

\*2007 Maintenance Assistant recruitment required candidates to submit copy of DMV driving record; significant number of candidates did not comply.

As the data shows, none of these recruitments generated fewer than 75 applicants who passed the test. This suggests that if the City were to lower the entry-level salary for these positions they could reduce labor costs and still attract and retain qualified employees. The City should implement a pilot program to create a lower entry-level salary for positions that result in a large number of qualified applicants.

This new lower-level salary would not affect employees currently filling these classifications. New employees could be hired at the lower level and then progress through an expanded salary range and eventually into the current salary range for the position. This would result in cost savings for the City as the employee is learning the position and progressing through the salary steps. This is similar to the concept of internships or apprenticeships; strategies commonly used by both public and private employers to attract quality employees at a lower cost temporarily. The new entry-level salaries would need to be negotiated with the appropriate bargaining unit.

The estimated annual cost savings to the General Fund for the recommendation is \$700,000 to \$1.7 million. It is important to note that these positions are generally entry level and non-professional. They do not require a lot in the way of prior experience and education. For positions such as these, the City is an extremely attractive employer relative to the private sector, offering excellent benefits and a defined benefit retirement program. For professional positions, particularly those that are technical or managerial, the City faces a much more competitive environment with respect to the private sector (which continues to employ the majority of workers).

The above estimate is based upon an assumption that 147 of the positions filled on an annual basis will be assigned an entry-level salary which is 12% to 23% less than the current entry-level salary, (but in no event below the applicable living wage). It also assumes that the City will experience approximately 10% turnover in General Fund positions and that 30% of the positions will be covered by the pilot program. Assuming a \$50,000 per year salary, the savings would be \$6,000 to \$12,000 per employee annually for a total of \$700,000 to \$1.7 million. In this case the lower estimate of the savings range is considered more likely in the short term.

**c. Implement Health Care Plan Modifications  
(\$1.2 to \$4.6 million)**

The City of San José can achieve cost savings by revisiting its healthcare programs. While doing so would require negotiations with the City's labor unions and with the healthcare providers currently under contract, the financial gains could be sizeable. Options to reduce costs include:

- Revising the cost sharing formula
- Implementing a wellness program

Since 2003, the City's annual healthcare premiums for active employees have increased by 79% for both single and family coverage plans. For example, in 2003, the annual family coverage premium for the City's lowest cost plan (Kaiser) was \$7,300 per employee; in 2008, the annual family coverage premium for the same plan is \$13,000 per employee.

The City of San José provides a total of six healthcare plan options to qualified active employees. Each plan offered has individual and family coverage options. The City's healthcare plans are structured as a cafeteria system, which allows employees to make strategic choices about the level and type of coverage they wish to purchase. Specifically, the plans are:

- Kaiser Permanente – Health Management Organization (HMO) Single and Family coverage
- Blue Shield – Health Management Organization (HMO) Single and Family coverage
- Blue Shield – Preferred Provider Organization (PPO) Single and Family coverage

As of January 2008, the healthcare cost sharing formula for all 12 employee units is 90/10. Ninety percent of the lowest plan (Kaiser) premium is paid by the City and the remaining 10% is paid by the employee. Should employees elect to participate in any of the Blue Shield plans, they are responsible for the additional premium cost above the 90% of the lowest plan (Kaiser).

Table 23 below outlines the premium cost sharing structure for each of the City's healthcare plans of permanent full-time workers. Due to the discrete differences in the copayment maximums among various employee units, the figures presented in Table 24 represent the average cost sharing structure for City healthcare plans.

**TABLE 23: PREMIUM COST-SHARING STRUCTURE OF CITY HEALTH PLANS**

	Kaiser Permanente		Blue Shield HMO		Blue Shield PPO	
	Single	Family	Single	Family	Single	Family
Employee Contribution	\$ 550	\$ 1,369	\$ 793	\$ 2,427	\$ 3,404	\$ 9,110
City Contribution	\$ 4,963	\$ 12,359	\$ 4,965	\$ 12,366	\$ 4,973	\$ 12,386
Total Premium	\$ 5,513	\$ 13,728	\$ 5,758	\$ 14,792	\$ 8,378	\$ 21,496

### Revise the Cost Sharing Formula

Each year the Kaiser Family Foundation and the Health Research and Educational Trust (Kaiser/HRET) conduct a survey of employer-sponsored health benefits. The survey contains data from almost 2,000 firms across the nation. The data is presented by health plan type and industry.

According to the 2006 Kaiser/HRET survey, the average percentage of premium paid by workers with healthcare in the state/local government sector is 13% for single coverage and 22% for family coverage. At present, the City of San José employees pay 10% for either single or family. Table 24 below shows the Kaiser/HRET average as a model and projects the savings to the City's General Fund at various levels.

**TABLE 24: POTENTIAL SAVINGS FROM COST SHARING CHANGES TO HEALTHCARE**

Percentage of Premiums Covered by Employee	Employee Share of Premiums	City Share of Premiums	Annual General Fund Savings	Three-Year General Fund Savings
10% Single and Family	\$3,792,722	\$34,331,285	No change	No change
13% Single Coverage, only	707,263	5,186,597	119,161	357,482
22% Family Coverage, only	7,090,632	25,139,514	3,886,013	11,658,039
13% Single and Family	4,956,121	33,167,886	1,163,399	3,490,197
22% Single and Family	8,387,281	29,736,725	4,594,560	13,783,679

As shown in the above table, if the City were to adjust its co-pay to the average level documented in the Kaiser/HRET study it could save \$5.1 million. However we conservatively estimate savings at \$1.2 to \$5.1 million based on the fact that the City may want to provide a better than average level of coverage and/or phase in changes.

### Wellness Programs

Another potential way to decrease healthcare costs is to invest in health prevention programs. By keeping employees healthy, employers can reduce the cost of claims. Employer-sponsored wellness programs reduce future costs and improve the quality of employees' lives. Wellness programs take many forms including, but not limited to, annual health assessments, incentives for good-health behavior (i.e., discounts for non-smokers), full or partial reimbursement for fitness club memberships, and employee athletic programs (i.e., cycling clubs).



As an employer, Kaiser Permanente is a leader in employee wellness programs. Kaiser offers a variety of classes to its employees that aim to improve nutrition, reduce stress and assist with weight loss. Employees can elect to participate in Kaiser's online Health Appraisal Program. The program begins with an online survey and concludes with a personalized health action plan. Throughout the year, the Health Appraisal Program provides periodic emails to participants, informing and reminding them of the goals in their personalized action plan. Kaiser's online Health Appraisal Program is available free of charge to all members. The healthcare provider is exploring the idea of making the program available to non-Kaiser members whose employer offers Kaiser as one of several healthcare plans.

King County, Washington's Healthy Incentive Program is a model that is worth examining for application in San José. The County set out to lower the increasing trend of healthcare costs by reducing risk factors, obesity, and the incidence of disease among its workers. Initiated in 2007, the program provides financial incentives for members to participate in disease management and other health-promoting activities.

A September 2006 primer from the California Healthcare Foundation titled "Managing the Costs of Health Care Coverage: Emerging Practices Among Public Sector Employers" describes the King County program. According to the primer under the Healthy Incentives Program, employees receive the same level of medical coverage they previously received but their participation in Health Incentives affects their out-of-pocket expenses. There are three out-of-pocket expense levels, as shown in the table below.

**TABLE 25: COMPARISON OF DEDUCTABLE VARIATION KEYED TO WELLNESS PROGRAM**

	<b>Gold</b>	<b>Silver</b>	<b>Bronze</b>
<b>Annual Deductible</b>	\$100 Individual \$300 Family	\$300 Individual \$900 Family	\$500 Individual \$1,500 Family
<b>Co-Insurance (in-network provider)</b>	10% (County pays 90%)	20% (County pays 80%)	20% (County pays 80%)

A member who takes the wellness assessment earns silver. A member who takes the wellness assessment and follows up with an individual action plan tailored to the member's risk of developing or controlling a chronic disease earns gold. If a member does nothing, s/he earns a bronze. The out-of-pocket level for the entire family will be based on the family member earning the fewest points.

At its core, the King County Healthy Incentives Program, along with most wellness programs, aim to achieve longer term goals rather than short-term cost savings. The Employee Benefit Research Institute produced a fact sheet on their findings related to wellness programs.

We are unable to impute an estimated cost savings based on the limited data that exists. However it is likely that this tool could build on the cost savings recommended in the above discussion on cost sharing.

**d. Implement Sick Leave Payment Modifications On Retirement (\$1.8 million)**

The City of San José, like many cities, offers payment of accrued sick leave upon retirement with a qualified number of years of service. The current sick leave payout policy provides for payment of 100% of accumulated select leave for police and fire employees upon retirement. Other employees receive payment for up to 75% of accumulated sick leave up to 1,200 hours.

The average total sick leave payout for the last five years amounted to \$5,816,000 for an average of 184 employees. The average payout was \$59,000 for police and fire employees, with some individuals receiving in excess of \$125,000.

As previously discussed, the City needs to reduce the rate of growth in personal services in order to reduce the structural deficit. The sick leave payout is a benefit the City simply cannot afford. Reducing this benefit is an opportunity to reduce personal services costs without affecting recruitment and retention of employees.

Some argue that sick leave payout is an incentive for staff not to abuse sick leave throughout the year since everything they accrue will be paid to them at retirement. Others argue that this is an incentive for staff to come to work sick rather than use sick leave.

There is little measurable return on this investment and it is not a best practice for organizations seeking to reduce the cost of services. Reducing the sick leave payout policy would bring City policies in line with private sector employers. Changes such as elimination of this policy and/or establishment of a payout cap would need to be negotiated with bargaining units and may be perceived by employees as a substantial reduction in their benefits package. However, newer employees are less concerned as this is not a benefit they stand to receive anytime soon.

Eliminating the sick leave payout policy would save the City \$5.8 million annually. By placing even a reasonable limit on sick leave

payout, the City could benefit from significant savings. For example, a savings of \$10,000 per employee could save \$1.8 million annually. (184 employees x 10K)

### **5. Change Prevailing Wage Applications: Eliminate Service Contracts (\$1.2 million)**

The City's position on the payment of prevailing wages is important in that for FY 2006-07 the City awarded 301 service contracts worth \$42 million with prevailing/living wage requirements and 33 construction contracts for a total of \$271 million with prevailing wage provisions. These contracts in turn help drive General Fund expenditures.

The City initially began requiring the payment of prevailing wages in 1988 when the City Council adopted a resolution essentially setting up a policy which mirrored State law. It was applicable to construction projects and specified that the City would use the prevailing wage determinations of the State.

In 1989 this policy was amended to broaden it to include four specific services (residential street sweeping, Convention Center food services, parking lot management and janitorial services). The prevailing wage was also applied to City maintenance project contracts of over \$1,000 for City property. These provisions resulted in the inclusion of services and contracts which were not within the scope of state prevailing wage law. Therefore, the City had to set up its own process and procedure for establishing prevailing wages

Also in 1989 the City adopted a resolution requiring the payment of prevailing wages on all City housing projects of eight units or more.

In 1999 the City adopted a resolution approving a policy of requiring the payment of a living wage for workers employed by employers who are awarded City service contracts of over \$20,000 in certain categories of services or who receive direct financial assistance from the City. Living wage requirements are different from prevailing wage requirements in that they typically apply to non-construction service contracts and to workers that not likely to be unionized. However, in 1989, the City had essentially begun applying prevailing wage criteria to service workers in some designated areas, so it was made clear that when a contract could be subject to both the living wage and prevailing wage requirements, whichever application resulted in the highest wage determination would govern. In virtually all cases this has turned out to be the prevailing wage.

This analysis only focuses on the application of those prevailing wage requirements which are, arguably, beyond the scope of current state law. While it might be theoretically possible for the City to opt out of the payment of prevailing wages based on the City Charter, this would be outside of the mainstream direction of California cities. Additionally while it might be possible to suspend prevailing wage increases during times

of financial stress under the same theory, it would probably not be feasible to craft such an approach that might cause the City to specify prevailing wages which are inconsistent with the current collective bargaining agreements between trades and construction contractors.

This analysis focuses on the application of prevailing wage law methodology to service contracts. This latter issue makes San José rather unique and may be an area where some cost savings can be achieved through policy change.

### ***Impact of Prevailing Wage on Service Contract Costs***

The City of San José has also applied prevailing wage methodology and requirements to a variety of service contracts. The City's Public Works Department Office of Equality Assurance (OEA) reports that 301 contracts, subject to either prevailing or living wage requirements, worth \$42 million were awarded in 2007. While the OEA does not have statistics for the number subject to prevailing wage compared with living wage requirements, a 2002 analysis found that out of a universe of 392 contracts in FY 2000, 153 were subject to prevailing wage requirements only, 177 were subject to both (but handled as prevailing wage eligible because the wage was higher) and 57 were subject to the living wage.

Currently the department is calculating prevailing wages for at least the following service types:

- Street sweeping
- Residential garbage and recycling
- Food services at the Convention Center and other locations

In many cases employees covered under the contract earn a market rate which is more than living wage but may be less than the prevailing wage. The development of prevailing wages for positions not covered under the Department of Industrial Relations represents a large workload for the OEA. This, along with other cutbacks has resulted in the need to prioritize which contracts are actively monitored. In 2007, 120 construction contracts (totaling \$1.5 million) were not actively monitored and 145 service contracts (totaling \$15 million) were not actively monitored. On average, the City receives \$665 in underpayments and penalties for each \$1 million in contracts monitored. Implementing 100% monitoring is likely to increase collections by at least \$11,000, but probably more, since small contract holders are aware they are unlikely to be monitored.

The argument can be made that the City would be better served if the OEA did not have to spend time developing and monitoring prevailing wages for positions that already make more than the living wage. Their time would be better spent concentrating on actively monitoring service contracts, especially those involving the lowest paid workers subject only to the living wage protections.

Overlapping prevailing and living wage policies are problematic. By maintaining both, the City creates a situation where costs for some service contracts are higher than they would be if the City was fully in conformance with State Labor Code requirements concerning prevailing wages and in conformance with its own living wage policies.

For example, under current City rules a "Lead Person" under the parking lot maintenance contract is subject to payment of prevailing wages. This is a result of the resolution adopted in 1989 creating special prevailing wage classifications above and beyond those specified in state law.

To comply with this City regulation, OEA creates a wage determination for this position through its own process which is time intensive and often confusing. Currently the prevailing wage rate for this position is \$19.25 per hour. If this contract was simply subject to the living wage, the required wage rate would be from \$12.27 to \$13.91 (depending on benefits offered). City parking contracts are worth over \$6 million per year, and as previously noted, the City contracts for over \$40 million in services that is subject to some combination of prevailing or living wage requirements.

Currently most contracts are subject to prevailing wage interpretations and this is increasing City costs by an unknown amount due to compliance with the living wage. (In most cases the market rate is above the living wage, but not necessarily above the prevailing wage calculation). Furthermore there is no "bright line" that explains why some types of contracts are subject to prevailing wage determination (e.g., food service workers) while others (e.g., security guards) are not.

Calculating savings to the City resulting from this policy change will require more analysis than can be accomplished in the timeframe available to the City Manager's Task Force; however, using conservative estimations, an estimate can be generated. The differential in the example involving the parking lot lead worker amounts to a 28% savings, and this is probably not atypical. We can assume a more conservative 15% differential as was done in the earlier example involving prevailing wages. Prevailing wage contracts are about 85% of the total service contracts which, in 2007, amounted to a value of \$42 million. Assuming that labor is approximately 70% of typical contract costs and applying the 15% differential to those contracts subject to a prevailing wage yields a potential savings estimate of \$3.7 million. Not all of this would accrue to the General Fund, but assuming a savings of one-third, the City would see potential savings of \$1.2 million.



## **LONGER RANGE STRATEGIES**

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One of the challenges the City Manager's General Fund Structural Budget Deficit Task Force faced was the fact that realistic solutions must be implemented in three years. Many good ideas for improving the City's budget position will take more than three years to pay dividends and thus were excluded from the list of suggested strategies. Nevertheless, some brief discussion about the best long-term strategies is merited. More importantly, the City needs to have a long-term financial strategic plan that will frame these issues and keep them as a focused priority. The budget principles discussed later in this report speak to cementing this outlook into the City's planning.

Three major issues merit attention here: economic development opportunities, the potential for a two-tier retirement system, and the need for sustained lobbying efforts at the federal and especially state level to address systematic problems in California local government finance. These strategies were all articulated during the stakeholder meetings as well as meetings of the BSAG.

### **Economic Development**

Some of the more powerful comparisons in this report are those showing per capita tax revenues in San José and surrounding cities. San José lags considerably in sales tax revenues and property tax revenues per capita. Perhaps the most realistic way for the City to address this is via economic development efforts.

It is apparent that the City pays a price in terms of tax revenues because that it tends to house many workers in Santa Clara County and San Mateo County, but does not have a consummate share of sales tax and property tax revenues. It will take years to address this imbalance, and there are literally dozens of efforts underway now to do so. This must stay a constant priority for the City.

## **Two-Tier Retirement System**

In Fiscal Year 2007-08 retirement expenses to the General Fund were over \$102 million. This represents an increase of \$49 million since 1996 when the expense was \$52.8 million.

The City's current defined benefit retirement program provides excellent benefits for retirees. Unfortunately, it is also much more expensive than had been anticipated and serious consideration should be given to making plan modifications given the City's financial position. Two prevailing options are feasible: implementing a new lower cost defined benefit plan or moving to a defined contribution plan such as is common in the private sector. The first option is less disruptive and has been successfully implemented in other California jurisdictions. The second option is less common in the public sector and unknown in large cities in California.

Although defined benefit pension systems previously were common in the private sector, they are now very rare because companies have determined it is difficult to compete in a global market with such expensive retirement programs. The vast majority of private employers in San José have established a defined contribution retirement programs such as a 401(k). These employers typically contribute from 6% to 10% to match employee contributions in the 401(k) accounts.

Although a generous defined benefit pension system has traditionally been a part of public employment, it is only one factor that potential employees consider as a part of the total compensation. A defined contribution retirement system would cost substantially less than the City's current pension system and would allow the City to use some of the savings for other programs to attract and keep high quality employees.

As with a change to a less generous defined benefit program, savings from a defined benefit plan would only accrue over time. However, the savings would be substantial. Such a step must be considered as a part of any considerable structural deficit reduction effort, even though we cannot assume it will bear much fruit in the coming three years.

## **Towards a Better System of Local Government Finance**

California's system of local government finance has been described as dysfunctional. It provides little in the way of transparency for the taxpayer and relies on a disjointed system of responsibilities among the state, counties, cities and special districts.

Many of the constitutional initiatives passed regarding local government finance in the last 30 years have had unintended consequences and



have spawned incentives that are actually contrary to sound public administration principles and accountability to taxpayers. As just one example, these initiatives have had the effect of transferring power from local government to the state, which is far removed from municipal affairs and which has a legislative and executive system largely driven by partisan politics.

The state has played a leading role in removing local property tax from the control of local officials, while also taking a lead in providing the pension enhancements that form such an expenditure problem for local governments. This is not just a California phenomenon, but it is probably most acute in California, which has helped shape the national agenda on this issue since the passage of Proposition 13 in 1978.

A recent study by the Brookings Institute *Budgeting For Basics: The Changing Landscape of City Finances – 2005* made the following findings:

*Along with their federal and state counterparts, city government officials have ridden a fiscal roller coaster since the late 1990s. The relatively prosperous times at the end of the last decade turned into a period of fiscal strain after 2001 and the effects of that downturn lingered for most cities.*

*A review of the long-term fiscal trends that preceded this latest fiscal shock, along with an analysis by city chief financial officers of the causes of their current fiscal problems and how they responded, offers important insight into the fiscal situation of cities as they move forward. Several important findings emerge from the analysis of fiscal trends over the twenty-three year period from 1977 to 2000.*

*Local government is the level of government generally most favored by citizens, yet general expenditures in these cities grew more slowly than did other types of government. Spending on the high priority areas of police and education did grow more than other areas, especially in the 1990s, but cities were generally fiscally conservative during the decade, even with the opportunity of growing revenues.*

*From fiscal year 2003 to 2004 CFOs indicated that fiscal conditions in their cities declined, while budget pressures increased. CFOs characterize the problem as mostly a structural one, despite the recent economic downturn. Revenue inadequacy is seen as a significant concern in many cities, while expenditure pressures, especially in public safety, education, and employee benefits remain strong. Many city officials would like provide their citizens with new and expanded services, but are restrained from doing so by limited tax options, tax and expenditure limitations, and/or taxpayer opposition to raising revenues.*

*In sum, cities, like their counterparts at the federal and state level, face the unenviable task of trying to satisfy citizen wants without alienating voters by increasing taxes. Without the deficit financing option available at the federal level, and, lacking the revenue options and broader base of state*

*government, city officials face a difficult balancing act. The long-term efficacy of recent short term responses is yet to be determined.*

Part of San José's long-term financial strategy must be to engage the state in a meaningful discussion of local finance reform. As the third largest city in the state, the City must take a leadership role.

## **BUDGET PROCESS REVIEW**

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The development and adoption of the annual budget is the most important responsibility for the city administration and the most critical policy decision made each year by the Mayor and City Council. In San José the annual budget allocates \$3.7 billion in resources to provide services to nearly one million residents. The budget process in San José has continued to evolve and be improved by the City staff, Mayor and City Council. San José has been recognized by the Government Finance Officers Association for consistently using best practices in the development and presentation of the budget document. The City's overall financial management and budget practices have allowed the city to maintain one of the highest bond ratings of any big city in the country.

The process in San José is designed to integrate the roles and responsibilities of three major players: 1) City residents, 2) Mayor and Council, and 3) City staff.

### **City Residents**

During the development of the FY 2007-08 budget, the City embarked on a new and markedly different public process leading up to the creation of the proposed budget. Early in January a telephone poll of 450 residents was conducted in English, Spanish and Vietnamese. Residents were asked about their opinion regarding current spending and priorities for allocation of resources. Following the telephone survey, a neighborhood association budget priority setting session was held on a Saturday. During these facilitated discussions, neighborhood leaders had an opportunity to discuss budget priorities and agree on five key priorities. These priorities formed the foundation for the development of the budget by the Mayor and Council and City staff.

### **Mayor and City Council**

The role of the Mayor and City Council in the budget process is to be aware of, and reflect the values and priorities of, the community; to establish key budget goals and priorities; to adopt financial policies and principles; and to make the final decision regarding the allocation of resources for City services and facilities. During development of the

current budget, the Mayor and City Council followed the survey and the neighborhood meetings with a full day priority-setting session to review priorities from the survey and neighborhood meetings. Based upon this guidance from the public, the Mayor and Council adopted five three-year goals for the budget. (One of these five goals is to eliminate the structural budget deficit and has led to the Mayor's Budget Shortfall Advisory Group, the City Manager's General Fund Structural Deficit Task Force, and this report.) After the Mayor and Council establish the goals and priorities, the City Manager prepares the proposed budget for City Council review. Several work sessions and public hearings are held on the various elements of the budget and, after revision by the Mayor and City Council, the budget is adopted.

## **City Staff**

The City Manager and Budget and departmental staff are responsible for the preparation of the proposed annual budget that reflects the priorities and goals of the Mayor and Council. They are also responsible for budget administration and control of the adopted Council budget. Staff monitors revenues and expenditures monthly during the year and periodically reports financial status to the City Council. Staff is also responsible for the development of long-range financial plans and business action plans.

The City of San José's budget process and schedule is well organized, transparent and effective. The adopted budget contains a one-page description of the process which illustrates the schedule and the role of the residents, the Mayor and City Council, and the City administration. The process involved in the development and adoption of the budget for a city the size of San José is virtually a year-round responsibility which culminates with the adoption of the budget in June, but begins anew shortly thereafter.

Although a good process is important, in the end the annual budget process is about making the difficult choices in the allocation of scarce resources in adopting a financial plan that is sustainable. Each year the choices made lead to long-term financial consequences and results for the City. The City of San José is a complex business with revenues of \$3.7 billion and almost 7,000 employees. Like any business of this size, the financial planning and budgeting system needs to focus the attention of the policy leaders on the key financial planning issues facing the community over the next five years. This is particularly true if San José hopes to be successful in eliminating the structural budget deficit. Although there is an active annual discussion regarding priorities and budget requests from departments and community groups, effective policy leaders must focus on a few key financial and budget principles and use these principles as guidelines and requirements to maintain financial stability and balance. Successful business and government organizations maintain the discipline to follow these principles in good

times and in bad, when the organization is enjoying substantial revenue growth, and when, inevitably, revenue growth slows and creates the gap between our needs, desires and reality. Indeed, one could argue that the key to maintaining financial stability for city government is to maintain fiscal discipline and principles during the boom times so that fewer damaging short-term decisions and actions are necessary during periods of slow economic growth.

While San José has extensive budget policies, they tend to be technically oriented and utilized in the development of a recommended budget, but not always followed when the budget is adopted and amended. In order to avoid another structural budget deficit the City needs to adopt budget principles which are relatively easy to understand and which can serve as a meaningful framework for maintaining the financial discipline crucial to a large organization like the City of San José.

As part of the General Fund structural deficit effort, the City Manager's Task Force was asked to develop such budget principles. A list of 12 recommended principles is listed below. This listing was developed from examining San José's existing budget policies, best practice policies and literature in the public financial management field. The principles should be simple and self explanatory.

## **Recommended Budget Principles for Consideration**

Best practice analysis indicates that San José could strengthen and simplify its budget policies into a series of principles the Council could adopt and practice. The Mayor's BSAG asked that staff draft some principles for consideration. We have done so, drawing on best practice research and the City's existing budget policies.

### **1) STRUCTURALLY BALANCED BUDGET**

The annual budgets for all City funds shall be structurally balanced throughout the budget process. Ongoing revenue shall equal or exceed ongoing expenditures in both the Proposed and Adopted Budgets. If a structural imbalance occurs, a plan shall be developed and implemented to bring the budget back into structural balance.

### **2) PROPOSED BUDGET REVISIONS**

The annual General Fund Proposed Budget balancing plan shall be presented and discussed in context of the five-year forecast. Any revisions to the Proposed Budget shall include an analysis of the impact on the forecast out years. If a revision creates a negative impact on the forecast, a funding plan shall be developed and approved to offset the impact.

### **3) USE OF ONE-TIME RESOURCES**

Once the General Fund budget is brought into structural balance, one-time resources (e.g., revenue spikes, budget savings, sale of property, and similar nonrecurring revenue) shall not be used for current or new ongoing operating expenses. Examples of appropriate uses of one-time resources include rebuilding the Economic Uncertainty Reserve, early retirement of debt, capital expenditures without significant operating and maintenance costs, and other nonrecurring expenditures.

### **4) BUDGET REQUESTS DURING THE YEAR**

New program, service or staff requests during the year that are unbudgeted shall be considered in light of the City's General Fund Unfunded Initiatives/Programs List and include a spending offset at the time of the request (if costs are known) or before final approval, so that the request has a net-zero effect on the budget.

### **5) RESERVES**

All City Funds shall maintain an adequate reserve level and/or ending fund balance, as determined annually and as appropriate for each fund. For the General Fund, a contingency reserve amount, which is a minimum of 3% of the operating budget, shall be maintained. Any use of the General Fund Contingency Reserve would require a two-thirds vote of approval by the City Council.

### **6) DEBT ISSUANCE**

The City shall not issue long-term (over one year) General Fund debt to support ongoing operating costs (other than debt service) unless such debt issuance achieves net operating cost savings and such savings are verified by appropriate independent analysis. All General Fund debt issuances shall identify the method of repayment (or have a dedicated revenue source).

### **7) EMPLOYEE COMPENSATION**

Negotiations for employee compensation shall consider total compensation bargaining concepts and focus on all personal services cost changes (e.g., step increases, benefit cost increases).

### **8) CAPITAL IMPROVEMENT PROJECTS**

Capital Improvement Projects shall not proceed for projects with annual operating and maintenance costs exceeding \$100,000 without City Council certification that funding will be made available in the applicable year of the cost impact.

### **9) FEES AND CHARGES**

Fee increases shall be utilized, where possible, to assure that fee program operating costs are fully covered by fee revenue and explore opportunities to establish new fees for services where appropriate.

#### **10) GRANTS**

City staff shall seek out, apply for and effectively administer federal, State and other grants that address the City's priorities and policy objectives and provide a positive benefit to the City. Before any grant is pursued, staff shall provide a detailed pro-forma that addresses the immediate and long-term costs and benefits to the City. One-time operating grant revenues shall not be used to begin or support the costs of ongoing programs.

#### **11) GENERAL PLAN**

The General Plan shall be used as a primary long-term fiscal planning tool. The General Plan contains goals for land use, transportation, capital investments, and service delivery based on a specific capacity for new workers and residents. Recommendations to create new development capacity beyond the existing General Plan shall be analyzed to ensure that capital improvements and operating and maintenance costs are within the financial capacity of the City.

#### **12) PERFORMANCE MEASURES**

All requests for City Service Area/departamental funding shall include performance measurement data so that funding requests can be reviewed and approved in light of service level outcomes to the community and organization.





## CONCLUSION

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Management Partners has analyzed many strategies that, if implemented, will resolve the structural budget deficit facing the City of San José's General Fund. Although the City budget is large and complex, the keys to eliminating the structural deficit and maintaining a sustainable financial plan are relatively straightforward. By definition, a structural deficit exists when the projected required annual expenses of the City's General Fund exceed the projected annual revenues on a continuing basis. Such a deficit requires that reserves, fund balances and other one-time measures be used to bridge the difference. The problem is that eventually these one-time fixes are exhausted. The straightforward solution to the structural deficit is to reduce expenses and/or increase revenues so that the projected revenues meet or exceed the projected expenses consistently on an annual basis.

The City's financial condition is the result of a series of choices made by the Mayor and Council annually as a part of the budget process in trying to meet the City's growing service demands and needs. If the City makes certain choices and difficult decisions as a part of the annual budget process, the result will be a sustainable financial future and a stable General Fund.

Conversely the financial actions that should be taken during the economic cycles that substantially increase revenues are primarily aimed at positioning the City for the inevitable downturns. Surplus revenue should be used to address known but unfunded infrastructure and maintenance deficiencies such as facilities renovation and major street and transportation facility renovations. Surplus revenues also offer the opportunity to fund other unfunded liabilities such as future pension obligations and equipment replacement, and to make contributions to "rainy day funds" to provide a cushion during the next economic downturn.

It is difficult to maintain the financial discipline required to make these choices during a substantial economic boom if appropriate policies are not in place. It is natural for both the staff and the Council to want to use "surplus revenues" to establish new services, to increase current service levels, to build new parks, streets, community centers, etc. For these reasons it is important that the City continue to develop and maintain its five-year long-range financial plan that comprehensively projects

expenditures and revenues and the resulting impact on fund balances and reserves.

Such a financial plan can continue to be used to model the future impact of investment or expenditure choices made today. For example, if the current budget contains the revenue to add 200 new positions to the workforce, will projected future revenue continue to support these and other expenditure commitments? In addition to the long-range financial projections, it is important to also adopt financial policies that support a sustainable financial environment for the City. The budget principles section of this report references several key policies that are necessary to ensure financial stability and integrity.

The City of San José, like other cities in California, must make these important policy choices in an environment that is characterized by transparency and responsiveness. Groups that represent the needs of the community are well organized and articulate. They each make persuasive appeals for the City to invest its scarce resources to increase service levels in traditional services such as public safety, parks and recreation, libraries, and more. Additionally there are many unmet needs that compete for the City's attention and funding.

One of the positive developments resulting from the Mayor's Budget Shortfall Advisory Group and the City Manager's General Fund Structural Deficit Task Force is the increased public knowledge and awareness regarding the issues and choices facing the City. For example, community discussion has led to the creation of at least one Community Budget Working Group to "assure that a broad range of voices can bring innovative ideas to elected leaders." The Mayor, Council and City staff members have established an expectation of public dialogue and will continue to encourage broad public involvement in these critical policy decisions.

The ultimate solution to resolve the structural deficit and to create and maintain a healthy financial environment involves hard choices on both sides of the spending and revenues equation. Ultimately, the financial policies and practices of the City should reflect the vision and values of the residents and taxpayers of San José. Although it is relatively easy to identify and articulate the prudent budget policies that will lead to financial sustainability, the appropriate balance between expenditures and revenues is less obvious. The role of the Mayor and Council is to create an environment in which they can engage in a conversation regarding important choices.

This report has provided many options and strategies to consider to achieve financial stability, including revenue strategies, service delivery model changes, expenditure controls and shifts, and service reductions. The residents of San José, through their elected leaders and ultimately at the ballot box, must decide the proper balance for themselves. Once those choices are made, it is crucial that the City establish and follow

prudent budget and financial policies which will lead to sustainable service levels and a balanced financial environment.